Course: **Management Accounting**	
Course Code: **MC- 105**	Author: **Dr. Suresh K. Mittal**
Lesson No: **1**	Vetter: **Dr. Sanjay Tiwari**

MANAGEMENT ACCOUNTING: MEANING, IMPORTANCE, NATURE AND OBJECTIVES.

STRUCTURE

1.0 OBJECTIVES

After going through this lesson, you should be able to:

- Know the meaning, functions and limitations of financial accounting
- Know the meaning, nature and tools of management accounting
- Explain the functions and objectives of management accounting
- Understand the limitations of management accounting.

1.1 INTRODUCTION

Accounting is the language of business. Accounting as a historical description of financial activities is no longer acceptable. Over a period of time new dimensions have been added in the subject of accounting. In modern era, Accounting is regarded as service activity the function of which is to provide quantitative information about business operations to various parties who have directly or indirectly some stake in the business i.e. proprietors, creditors, investors, researchers, government and other agencies.

1.2 ACCOUNTING AND FINANCIAL ACCOUNTING: MEANING

Accounting is mainly concerned with the collection, recording, classification and presentation of financial data for the use of many stakeholders. The role of accounting is changing day by day and now accounting is considered as a tool of management which provides vital information about the organization. In 1941, the American Institute of Certified Public Accountants (AICPA) defined accounting as: "Accounting is the art of recording, classifying and summarizing in significant manner and in terms of money, transactions and events which are, in part, at least of financial character and interpreting the result thereof".

In 1966, the American Accounting Association (AAA) defined accounting as: "Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information".

In 1970, the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) enumerated the functions of accounting as:

“The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions”.

On the basis of above definitions, accounting may be defined as the process of recording, classifying, summarizing, analyzing and interpreting the financial transactions and communicating the results to the parties which are interested in such information.

The term ‘Accounting’ can be classified into three categories:

i) Financial Accounting
ii) Cost Accounting
iii) Management Accounting

The main objective of Financial Accounting is to find out the profitability and financial position of an organization. There are two financial statements i.e. Income Statement and Balance Sheet. The Income Statement in prepared to know the profit or loss of business operations for a particular period, i.e. a year which is called accounting period which may be calendar year, financial year or any other period of 12 months. The Balance Sheet is prepared to show the actual financial position of business/firm at the end of the year. Balance Sheet shows the financial position on a particular date. It consists of the position of assets and liabilities of business.

1.3 FUNCTIONS OF FINANCIAL ACCOUNTING

Financial accounting provides information related to the financial position of business and results of business operations to different stakeholders such as owners, creditors borrowers, government, banks, financial institutions etc. Followings are the functions of financial accounting:

Recording: Accounting is the art of recording financial transactions and events of a concern. It is not possible to remember each and every transaction of the business. The transaction and events are recorded in the Journal and Subsidiary Books. The Subsidiary Books may be Cash Book, Purchase Book, Sales Book, Purchase Return Book, Sales

Return Book, B/R Book, B/P Book, and Journal Proper as per the requirement of the concern/firm.

Classifying: Classification is concerned with systematic arrangement of the recorded data with a view to group transactions or entries of one nature at one place. The work of classification is done in the book called 'ledger'. The book contains on different pages individual account heads under which all financial transactions of similar nature are collected and recorded.

Summarizing: It involves presenting the classified data in a manner which is understandable and useful to the different stakeholders of business. Summarizing function leads to the preparation of the following financial statements:

i) Trial Balance
ii) Income Statement
iii) Balance Sheet

Dealing with financial transaction: Accounting deals with only those transactions and events which are measurable in terms of money. Anything that cannot be measured in monetary terms does not form a part of financial accounting. For example, if a company has got a team of dedicated and trusted employees, it is a great of use to the business but since it is not a financial character, so it will not be recorded in the books of accounts of that business.

Analyzing and Interpreting: The recorded financial data are analyzed and interpreted in a manner so that the end users can make a meaningful judgment about the profitability and financial position of the business. Analysis and Interpretation are the terms which are used interchangeably but the term 'analysis' means methodical classification of data given in the financial statements and the term 'Interpretation' means explaining the meaning and significance of the data so simplified. Analysis of financial accounting data requires application of tools, techniques and methods whereas interpretation deals with representing the analyzed data in simple language.

Communicating: The profitability and financial position of the business are communicated through profit & loss Account and Balance Sheet. The parties which are interested in knowing the results or financial position of the business can make their own conclusions from financial statements.

Making information more reliable: Another important function of financial accounting is to make the information more useful and reliable. This is done by the use of international accounting standards and consistent use of accounting principles etc.

1.4 MEANING OF MANAGEMENT ACCOUNTING

The origin of Management Accounting can be traced to overcome the limitations of Financial Accounting. Financial Accounting is very useful to various stakeholders but it suffers from many limitations such as historical nature of data, provides information about the concern as a whole, cost control not possible, only actual costs are recorded, only quantitative information, lack of unanimity of accounting principles and problems of window dressing.

Management Accounting came into existence to reduce the limitations of financial accounting. Management Accounting comprises of two words; Management and Accounting therefore it is a study of managerial aspect of accounting. Management Accounting is the presentation of accounting information in such a way so as to assist management in policy formulation, control of execution and effectiveness. A small undertaking is generally managed by the owner himself. The owner is in touch with day to day working of the enterprise that also plans and controls the whole business himself. Since the owner is both the decision maker and implementer of such decisions, so he does not feel the necessity of any communication system and no additional information is required for taking the managerial decisions. All information needs for managerial decisions met by Income Statement and Balance Sheet. But the evolution of Joint Stock Company has resulted into large scale of production along with separation of ownership and management. In these large organizations, the decision making no more remains a matter of intuition and requires the evolution of effective information system for providing relevant information for taking managerial decisions. In other words, the accounting information required for taking managerial decision is the subject matter of management accounting.

DEFINITIONS OF MANAGEMENT ACCOUNTING

1. Anglo- American Council on Productivity: "Management Accounting is the presentation of accounting information in such a way as to assists management in the creation of policy and the day-to-day operation of an undertaking".

Management accounting deals with the presentation of information so that it is helpful to management. Management likes to base its policy decisions on some information and the information should be presented according to the needs of management. The main emphasis on this definition is on presentation of information and not the collection of the same.

2. **Robert N Anthony**: "Management Accounting is concerned with accounting information that is useful to management."

3. **T.G. Rose:** "Management Accounting is the adaptation and analysis of accounting information and its diagnosis and explanation is such a way as to assist management."

4. **Brown and Howard:** "The essential aim of management accounting should be to assist management in decision making and control."

5. **Broad and Carmichael:** "The term 'Management Accounting' covers all those services by which the accounting department can assist top management and other departments in the formation of policy, the control of the execution and appreciation of its effectiveness."

6. **Institute of Chartered Accountants of England and Wales:** "Any form of accounting which enables a business to be conducted more efficiently can be regarded as management accounting".

7. **N.K. Bose:** "Management Accounting is accounting for effective management."

8. **The American Accounting Association**: "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 performances."

8. The Association of Certified Corporate Accountants (USA) : "The Application of accounting and statistical techniques to the specified purpose of producing and interpreting information designed to assist management in the function of promoting maximum efficiency and in envisaging, formulating and co-coordinating their execution."

From the various definition discussed above, it is clear that accounting data are recorded, classified, summarized, analyzed and presented to the management in such a way that it is useful and helpful for taking managerial decisions effectively and systematically.

1.5 NATURE OF MANAGEMENT ACCOUNTING

Management accounting provides the data related to accounting to the management for taking various managerial decisions which helps in improving efficiency and effectiveness of managerial decisions. The following are the main characteristics of management accounting:

1. **Providing Accounting Information:** Management accounting provides the accounting information in such a way that is helpful for decision making. It is concerned with all such information's which are useful to management in decision making at different levels.
2. **Cause and Effect Analysis:** Financial accounting is limited to the preparation of financial accounts but management accounting also establishes cause and effect relationship between different variables. It there is loss, the reasons for the loss will be probed. If there is profit then factors affecting profit will also be studied.
3. **Use of Special Techniques and Concepts:** Management Accounting uses special tools and techniques to provide and interpret information for managerial decision making. The techniques used in management accounting are; analysis of financial

statements, standard costing, marginal costing; activity based costing and budgetary control.

4. **Internal Use:** Though Management Accounting in not mandatory like financial accounting, Information provided by management accounting are used for the internal control and generally not shared to external stakeholders.
5. **No Fixed Norms Followed:** Financial accounting is based on fixed norms and these norms should be strictly followed e.g. valuation of stock, method of charging depreciation etc., but in case of management accounting there are no fixed norms and management accountant can use the rules/norms in his own way. Therefore in case of management accounting, every concern uses its own rules and norms for analyzing the data or creation of any information for decision making.
6. **Increase in Efficiency:** Management accounting emphasize on efficiency. The efficiency can be increased by setting standards followed by actual performance is measured so that management is able to pin point inefficient spots and corrective action can be taken which leads to increase in efficiency.
7. **Supplies Information and Not Decision:** Management accounting supplies information to the management as required. The decisions are to be taken by the top management. The quality of decision depends upon the caliber and efficiency of the management and how they use the information provided by management accountant.

1.6 TOOLS AND TECHNIQUES OF MANAGEMENT ACCOUNTING

Management accounting uses a number of tools and techniques to facilitate management in taking managerial decision for achieving business goals. Some of the important tools and techniques are mentioned below:

1. Financial Accounting and Policy
2. Analysis of Financial Statements
3. Historical Cost Accounting
4. Standard Costing and Variance Analysis
5. Marginal Costing and Cost-Volume Profit Analysis
6. Differential Cost Analysis
7. Cash Flow Statement

8. Funds Flow Statement
9. Revaluation Accounting
10. Budgetary Control
11. Responsibility Accounting
12. Accounting for Price level Changes
13. Life Cycle Costing
14. Value Analysis
15. Management Information System
16. Activity Based Costing
17. Total Quality Management
18. Target Costing
19. Inventory Control

1.7 FUNCTIONS OF MANAGEMENT ACCOUNTING

Management accounting deals with providing information in such a way that it is helpful to the management in controlling and running the organization in an efficient and effective manner. Some of the functions of management accounting are given below:

1. **Forecasting and Planning:** Forecasting and planning are very important tools for achieving the targets of the organization. The management accountant uses various techniques such as budgeting, standard costing, marginal costing, analysis of financial statements which are useful for forecasting and planning activities of a concern.
2. **Modification of data:** Management accounting helps in modifying accounting data in such a way that it is very useful to the management. For example, if cost data is required, it can be classified as material cost, labor cost, overhead cost, avoidable cost, fixed cost, variable cost etc. which may be very useful to the management. So, the management accountant classifies and modifies the data according to the requirement of the management.
3. **Financial Analysis and Interpretation:** Financial statement such as Income Statement and Balance Sheet provide only absolute value but the decision is taken

on the relative values. For example, profits have relation/concerned with sales and capital employed. So, the management accountant compares the different values which are related and makes interpretation of the analysis.

4. **Facilitates Managerial Control:** Management accounting is very useful in controlling performance. For example, the standards/budgets are set up by using standard costing or budgetary control. The actual performance is recorded and deviations are calculated. It enables the management to assess the performance of each activity in an organization.
5. **Communication:** Communication is very important within the organization and with the outside world. The management accountant prepares various reports which are useful at different levels of management and employees. These reports are also communicated to the outsiders.
6. **Qualitative Information:** The Management accountant uses various kinds of qualitative information while providing information to the management. While preparing a budget, management accountant may not only use past figures but also assess the persons dealing with budget, consumer survey, macro analysis, political environment etc.
7. **Co-Ordinating:** Management accountant who acts as a coordinating agent helps in coordinating among different departments of the concern. The plans and performances of different departments are communicated to them. Master budget is prepared to co-ordinate the different budgets.
8. **Helpful in taking strategic decisions:** Management accounting helps in taking strategic decisions like replacement decision, expansion, diversification, make or buy decision, to enter in foreign markets etc.

1.8 OBJECTIVES OF MANAGEMENT ACCOUNTING

The main objective of management accounting is to provide accounting information in such a way so as to help to take corrective action. Aside from it, the following are the objectives of management accounting:

1. **Planning and policy formulation:** Management accountant prepares analysis of financial statements which are very useful for planning and policy formulation.

He also prepares estimates for the future by using different techniques like budgetary control, standard costing etc. He also suggests the best alternative for taking a decision. All these information supplied and opinions given by the management accountant facilitates planning and policy formulation.

2. **Helpful in Organizing:** Management accountant helps in organizing the activities of the organization by using the delegation of authority and fixing of responsibility. Management accounting helps in establishment of cost centers, preparation of budgets etc.
3. **Helpful in Co-coordinating:** Management accounting helps in coordinating the different activities of the organization. For example, while preparing purchase budget, production budget, sales budget, labor budget etc., he also prepares a master budget which helps in coordinating among different budgets.
4. **Helpful in Controlling:** Management accounting helps in controlling of different activities of the organization. Standard costing and budgetary control are the important techniques of controlling. The management is able to control performance of each and every individual with the help of techniques of management accounting.
5. **Helpful in Interpreting Financial Information:** Financial information is of technical nature and most of the time, managerial personnel are not able to understand the use and significance of these financial statements. Management accountant explains these statements to the management in a simple language by using ratios, charts, diagrams, index numbers etc., so that management can easily understand these figures and take appropriate decisions.
6. **Helpful in Communication:** Management accounting helps in keeping the management fully informed about the latest position of the business which facilitates the management in taking timely and right decisions. The management is being kept informed through regular financial reports and performance analysis of various departments to the management.
7. **Helpful in Qualitative Information:** Management accounting also helps in providing qualitative information to the management. Sometimes qualitative information is more important than quantitative information. For example

information regarding the dedication of employees, customers, quality of competitor’s etc. is supplied to the management for taking strategic decisions.

8. **Helpful in Decision Making:** Management accounting helps in decision making to the management by using techniques like marginal costing, differential costing, standard costing which helps in decisions such as pricing of products, make or buy decisions, discontinuance of product line etc.
9. **Helpful in Tax Administration:** Management accounting helps in assessing various tax liabilities and depositing correct amount of taxes with the authorities.

1.9 IMPORTANCE OF MANAGEMENT ACCOUNTING

The importance of management accounting is increasing day by day due to increasing complexity of business, large scale of operations, globalised business and role of technology in business. Management Accounting can play an important role in the existing business scenarios. The following are the advantages of management accounting:

1. **Increase in Efficiency:** Management accounting is helpful in increasing the efficiency of business operations. The targets of every department are fixed in advance and achievements of these targets are used as a tool of measuring their efficiency which helps in increasing the efficiency of departments and employees.
2. **Proper Planning:** Management accounting provides accounting information which helps to plan various operations of the organization. The technique of budgeting is helpful in forecasting and planning of different departments. Budgets are prepared and then master budget in prepared for coordinating the various budgets.
3. **Measurements of Performance:** The techniques of management accounting such as standard costing and budgetary control enable the management to measure the actual performance. Then actual performance is compared with standard performance, if there is any deviation corrective action is taken.
4. **Cost Control and Cost Reduction:** Cost control and cost reduction are the mantra of success in competitive business world. The technique of management accounting such as standard costing and budgeting help the management to

reduce and control the cost. The cost reduction helps in increasing the sales of the organization which helps in increasing the profitability of the organization.

5. **Effective Decision Making:** Management accounting helps in effective decision making with the help of providing right, useful and timely information to the management. The management accountant converts or creates the accounting information which is directly helpful for taking effective decisions. For example when profits are compared with sales volume or output is compared to capital employed it provides more relevant information to the management which results in effective decision making.
6. **Helpful in Management Control:** The tools and techniques of management accounting are helpful to the management in planning, coordinating and controlling activities of the organization. For example with the help of standard costing and budgetary control the management is able to know why actual performance is different form budgeted/standard performance. Thus deviations are detected and reported to the management.

1.10 LIMITATIONS OF MANAGEMENT ACCOUNTING

Though Management Accounting is very helpful for taking managerial decision, yet it suffers from the following limitations:

1. **Based on Accounting Information-** Management Accounting is based on the data supplied by financial and cost accounting. The effectiveness of management accounting depends on the accuracy and reliability of the accounting data. The financial accounting in based on some assumptions which also becomes the problem of management accounting.
2. **Lack of Knowledge:** The use of management accounting information requires the knowledge of a number of subjects/issues like accounting, statistics, economics, taxation, production etc. but the person who is taking the decisions may not have good knowledge of these subjects.
3. **Intuitive Decision:** It has been observed that management avoids lengthy information provided by management accounting while taking decisions. The

management prefers the decision on intuition based which limits the usefulness of management accounting.

4. **No Substitute of Administration:** The tools and techniques of management accounting provide only information and not decisions and the decision are taken by the management. So, management accounting has supplementary services and has not final say in taking decisions.
5. **Costly Affair:** The installation of management accounting system in a firm requires large organizational structure which requires a lot of funds. Therefore, it cannot be utilized by the small organization.
6. **Personal Biasness:** There are some areas of management accounting where may be the problem of personal biasness. For example interpretation of analysis of financial statements depends upon the capability, knowledge level, expertise and personal judgment of interpreter. Personal prejudices and biasness affect the objectivity of management accounting.
7. **Psychological Resistance:** The installation of management accounting system in an organization requires a lot of changes in organizational structure, rules and regulations. There changes are resisted by the management and employees of the organization because people are generating resistant to change.

1.11 SUMMARY

In modern era, Accounting is regarded as service activity the function of which is to provide quantitative information about business operations to various parties who have directly or indirectly some stake in the business i.e. proprietor, creditors, investors, researchers, government and other agencies. Accounting is mainly concerned with the collection, recording, classification and presentation of financial data for the use of many stakeholders. The role of accounting is changing day by day and now accounting is considered as a tool of management which provides vital information about the organization. In 1941, the American Institute of Certified public Accountants (AICPA) defined accounting as : "Accounting is the art of recording, classifying and summarizing in significant manner and in terms of money, transactions and events which are, in part, at least of financial character and interpreting the result there of ”. The term ‘Accounting’ can be classified into three categories:

i) Financial Accounting

ii) Cost Accounting and

iii) Management Accounting

The main objective of Financial Accounting is to find out the profitability and financial position of the organization. The two financial statements are the outcomes of financial accounting i.e. Income statement and Balance Sheet. Income Statement is prepared to know the profit or loss of business operations for a particular period, i.e. a year which is called accounting period which may be calendar year, financial year or any other period of 12 months. Balance Sheet is prepared to show the actual financial position of business at the end of the year. The Balance Sheet shows the financial position on a particular date.

Management Accounting came into existence to reduce the limitations of financial accounting. The Management Accounting is the presentation of accounting information in such a way as to assist management in policy formulation, control of execution and effectiveness of operations. A small undertaking is generally managed by the owner himself. The owner is in touch with day to day working of the enterprise and plans and control the whole business himself. As the owner is both the decision maker and implementer of such decisions, so he does not feel the necessity of any communication system and no additional information required for the managerial decisions. All information needs for managerial decisions are met by financial statements i.e. Income Statement and Balance Sheet. But the evolution of Joint Stock Company has resulted in a large scale of production along with separation of ownership and management. In these large organizations, the decision making no more remains a matter of intuition and requires the evolution of effective information system for providing relevant information for taking managerial decisions. In other words, the accounting information required for taking managerial decision is the subject matter of management accounting.

1.12 KEY WORDS

Trial Balance: Statement which is prepared to check the accounting errors.

Income Statement: A statement showing the results i.e. profit and loss from the operations of a business.

Balance Sheet: A statement showing the financial position of a business firm at a particular point of time. It includes assets and liabilities of business

Financial Accounting: Branch of accounting in which at the end the three financial statements are prepared i.e. Trial Balance, Income Statement and Balance Sheet.

Cost Accounting: Branch of accounting which is concerned with the determination of cost of products and services.

Management Accounting: Branch of accounting which facilitate managerial decision making.

1.13 SELF ASSESSMENT QUESTIONS

Q.1. What do you understand by Accounting? Discuss the functions of Financial Accounting.

Q. 2. Define the term Management Accounting. Explain the nature of Management Accounting.

Q. 3. Write a Detail note on tools and techniques of Management Accounting.

Q. 4. Elaborate the functions of Management Accounting.

Q. 5. Why there is a need of Management Accounting? Explain the objectives of Management Accounting.

Q. 6. Explain the importance and uses of Management Accounting.

Q. 7. What points should be kept in consideration while using Management Accounting.

Q. 8. Discuss the role of Management Accounting in an organization.

Q. 9. Differentiate the terms Financial Accounting, Management Accounting and Cost Accounting.

1.14 SUGGESTED READINGS

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Lesson No: **2**	Vetter: **Dr. Sanjay Tiwari**

SCOPE OF MANAGEMENT ACCOUNTING AND ITS DISTINCTION WITH FINANCIAL AND COST ACCOUNTING

STRUCTURE

2.0 OBJECTIVES

After going through this lesson, you should be able to:

- Understand the reasons of emergence of Management Accounting.
- Know the scope of Management Accounting
- Distinguish between Financial Accounting and Management Accounting
- Distinguish between Cost Accounting and Management Accounting.

2.1 INTRODUCTION

Accounting is the process of recording of business transactions and events in the books of original record, classifying them into the ledger and finally summarizing them by preparing financial statements i.e. Income Statement and Balance Sheet or computation of cost and control of cost. In addition to it, accounting helps in planning and policy formulation, controlling of business events, evaluation of performance and taking managerial decisions which is known as management accounting. Management Accounting has been developed to facilitate the management for taking managerial decisions. The term 'Management Accounting' is of recent origin. The term was first used in 1950 by a team of accountants visiting U.S.A. under the auspices of Anglo-American council on productivity. The term Management Accounting is comprised of two words 'Management' and 'Accounting' which means study of managerial aspects of accounting. Management accounting reproduces/ creates the accounting information in such a way that is helpful to the management in planning and policy formulation, control of execution and leads to more effectiveness. The evolution of Joint Stock Company has resulted in large-scale production and professionalism in management. In this scenario, the decision making no more remains a matter of intuition but requires the evolution of information system for helping management in taking managerial decisions. It may be concluded that management accounting uses all techniques of financial accounting, cost accounting and statistics to collect and process data for making it available to management so that it can take timely and correct decisions.

2.2 SCOPE OF MANAGEMENT ACCOUNTING

Management accounting provides the accounting information to the management in such a way that is directly useful for taking managerial decisions. For creating information to management, the management accountant uses different disciplines/areas of knowledge which constitute the scope of management accounting:

1. **Financial Accounting:** Financial accounting deals with the historical data. Financial accounting is mainly concerned with recording, classifying and summarizing of financial transactions and events. At the end the financial accountants prepare two statements i.e. Income Statement and Balance Sheet. In this way the financial accounting is based on the events which are already taken place, but management accounting is more concerned with the future so that the planning and policy for the organization can be formulated. For preparing plans, the financial accountant uses historical data related to financial position and profitability of the business which is available in financial accounting. So management accounting is closely related to financial accounting.
2. **Cost Accounting:** Cost accounting provides various tools and techniques for determining the cost of products or services. The cost control and reduction are very important aspects to succeed in business in competitive environment. Management accountant uses different tools and techniques of cost accounting which are very useful for taking managerial decisions. For example, budgetary control and standard costing are very helpful for controlling the cost of products. Marginal costing is very helpful to take managerial decisions related to make or buy decision and fixation of selling price. Thus, management accountant uses tools and techniques of cost accounting which is helpful to create important information. In this way, we can say that cost accounting and management accounting are closely associated.
3. **Budgetary Control & Forecasting:** Management accountant plays very important role to plan business activities for the future. For plan future, forecasting and budgeting are key instruments. Forecasting helps in the preparation of budgets like sales budget, purchase budget, material budget, labor budget and for coordinating purpose master budget is also prepared. Budgeting helps in exercising budgetary

control through which actual performance is compared with budgeted performance and corrective actions are taken if there is deviation between budgeted performance and actual performance. Therefore, both budgeting and forecasting are useful tools in the hands of management accountant.

4. **Financial Management:** Financial Management is concerned with the raising of funds and proper utilization of funds. Finance has become much important as all managerial activities are concerned with finance. Management accountant considers financial position of the business while providing information to the management. For management accountant, it is very important to know the solvency and liquidity position of the business. In this way, financial management and management accounting are closely associated with each other.
5. **Reporting to the Management:** For right and timely decisions, there should be a system of reporting to management. Management accountant prepares special reports and routine reports to the different levels of management as per their requirements.
6. **Statistical Tools:** Management accountants use statistical tools for creation of information and for preparation of reports. Statistical tools such as graphs, charts, tables, Index numbers, measurement of central tendencies etc. are very useful in management accounting.
7. **Financial Analysis and Interpretation:** In financial accounting, Income Statement and Balance Sheet are prepared at the end of accounting period. A lot of historical data are stored in these statements but the data have to be converted by management accountant into useful information with the help of tools and techniques of analysis and interpretation of financial statements. For example, with the help of absolute value of profits we are not able to draw any conclusion but if profits are compared with sales and capital employed, last year profit and competitive firm than more conclusive information can be drawn which is more useful for the management.
8. **Control Procedures and Methods:** Management accounting is not effective without using control procedure and methods such as inventory control, labour control, overhead control etc. Management accountant should have good knowledge of control procedures and methods for achieving the targets of the organization.

9. **Internal Control and Internal Audit:** Finance is very sensitive issue in every organization. Liquidity as well as solvency of the organization should be maintained at every cost. So, management accountant uses internal control and internal audit to check the loopholes in the financial system of the organization.
10. **Tax Accounting:** Management accountant uses tax planning methods to reduce the tax liability. It is an important part of management accounting which includes computation of tax liability and filing of tax return.
11. **Office Services:** Management accountant is expected to maintain and control office services such as processing of data, filing, copying and communicating.

2.3 Relationship between Management Accounting, Cost Accounting and Financial Accounting: Financial accounting, cost accounting and management accounting are closely linked with each other. Financial accounting is concerned with the recording, classifying and summarizing the financial data. At the end of accounting year two statements i.e. Income Statement and Balance Sheet are prepared. These two statements are used by the management accountants to draw the meaningful information for decision taking. For meaningful information, he generally analyses financial statements. For example, to draw meaningful conclusion regarding the profitability of the concern, the management accountant compares the profit with sales, capital employed, last year's profits and profits of the competitors. In the same manner he draws meaningful conclusions regarding liquidity position and solvency position etc. Therefore, it can be concluded that financial accounting and management accounting are closely interwined with each other and financial accounting provides a lot of information to management accounting. In a competitive business world, cost control and cost reduction are very important aspects for the survival as well as for growth of the business. There are many situations in which management accounting takes decision on the basis of cost information. For example, to make or buy decision, to enter in foreign markets or to sell, lower the cost etc. All these information are created by using marginal costing. For the purpose of cost control, the standard costing and budgetary control are very helpful in which actual cost/budgeted performance is compared with the actual cost/actual performance, if there is any deviation exist then corrective actions are taken so that standard cost and actual cost become the same. Hence, standard costing and budgetary control are very important tools of control. In this way cost accounting is very helpful for management accounting. The following diagram shows the relationship between financial accounting, cost accounting and management accounting.

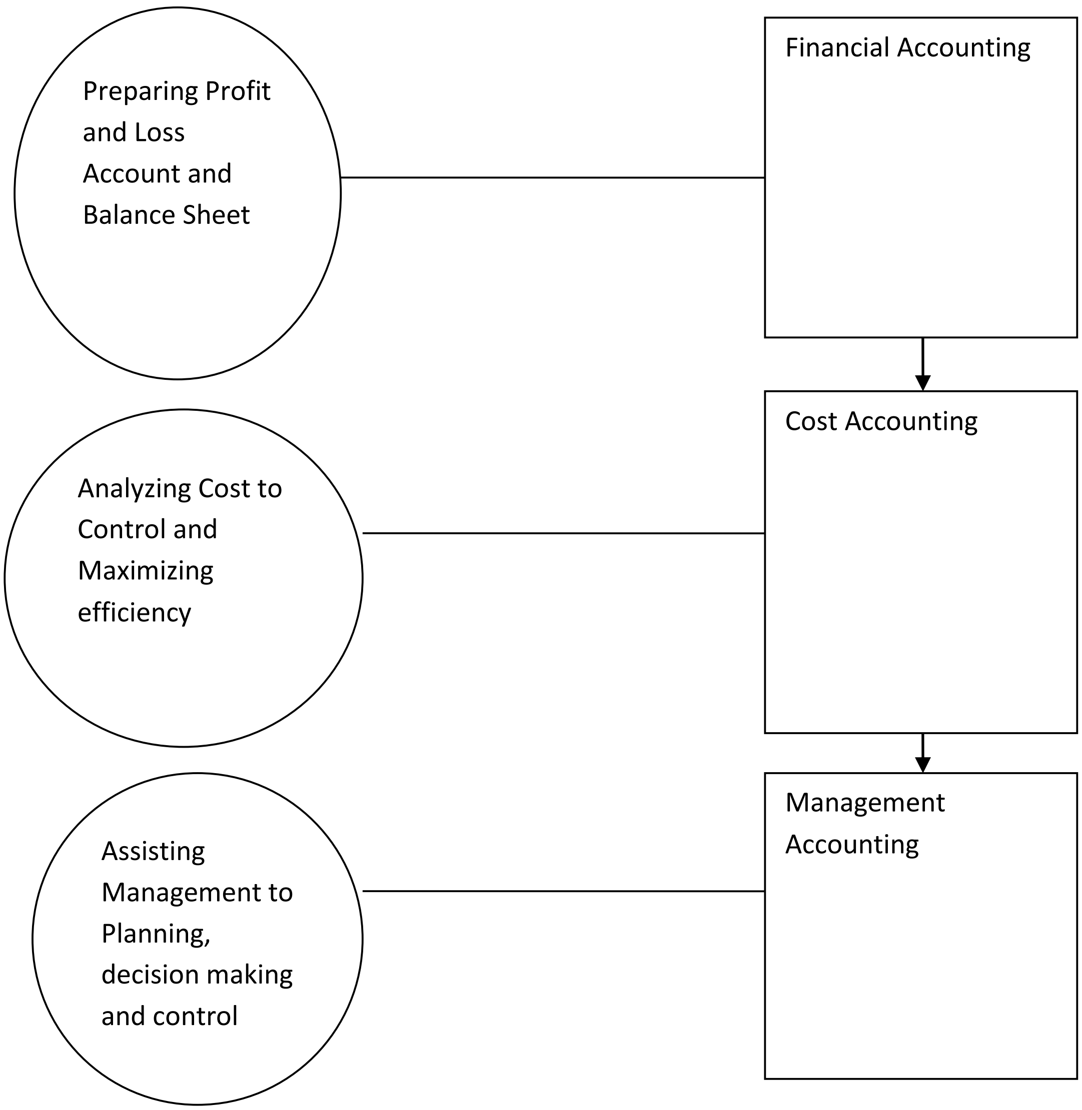

Chart 1: Relationship among financial, cost and management accounting

2.4 Distinction between Financial Accounting and Management Accounting:

Financial accounting is mainly concerned with the recording, classifying, summarizing, interpreting and reporting of the day-to-day transactions of business.

The financial accounting at the end of accounting period enables to prepare Income Statement and Balance Sheet. Income Statement depicts the profitability of the business and Balance Sheet tells the financial position of the business at a particular point of time. On the other hand, management accounting uses financial accounting and uses other information in such a way that these are helpful to the management for taking managerial decisions. In this way, financial accounting is very useful in management accounting. On this basis it can be concluded that financial accounting and management accounting are complimentary and are necessary in running the business efficiently and effectively. Despite this, there are some points of distinction between financial accounting and management accounting which are discussed as below:

Point of Distinction	**Financial Accounting**	**Management Accounting**
Objective	The main objective of financial accounting is to record, classify and summarize the financial data to know the financial position of the business and to find out the profit or loss at the end of accounting period.	The main objective of the management accounting is to reproduce/create the data into information which are useful for taking managerial decision e.g. formulation of plans and policies.
Nature	Financial accounting is mainly concerned with the historical data. It records any those transactions and events which have already taken place.	Management accounting is mainly concerned with the future because all the decisions are related to future like; planning and policy formulation. Management accounting mainly uses projected data or estimated figures. Historical data is used

		for projection of data.
Statutory Requirements	Financial accounting is obligatory to satisfy various statutory provisions under company law and tax laws etc. There are set procedures in financial accounting.	Management accounting s not obligatory. It is only a service function and helpful in management. There are not set procedures in management accounting.
Precision	Financial accounting is very precise because transactions are recorded only when they have taken place.	Management accounting is not precise because projected figures are used in management accounting even though they may be based on financial accounting.
Monetary and Non-Monetary Measurements	Financial accounting deals with only monetary data because all the transaction and events are measured in monetary terms only.	Management accounting deals with monetary as well as non-monetary data. It takes qualitative data as well.
Accounting Principles	Financial accounts are governed by the generally accepted accounting principles because the information of financial accounting is used by outsiders.	There are no set of rules in management accounting as the requirements of the business determine the methods of presenting figures.
Users of Accounting information	Information of financial accounting s mainly used by external parties e.g. bankers, investors, shareholders, creditors, employees, customers and Govt. etc.	Information of management accounting is mainly for the internal users i.e. management.
Subject Matter	Financial accounting deals	The management accounting

	with the all the activities of the business. The income statement shows the results of the business as a whole and balance sheet shows the financial position of the business as a whole.	deals with different units separately, departments and cost centers. In management accounting, analysis of data and evaluation is done from different angles.
Reporting	Financial reports i.e. profit and loss account and balance sheet are prepared usually on a year to year basis. Nowadays, in case of company organization, the financial reports are prepared on quarterly basis.	Management accounting reports are prepared frequently i.e. monthly, weekly or even daily basis depending the requirements of management.
Accounting Method	Financial accounting is based on double entry system of accounting for recording the business transactions.	Management accounting is not based on double entry system of accounting.
Accounting Standards	Financial accounts are prepared as per accounting standards issued by ICAI.	Management accounting is not bound to use accounting standards used by ICAI.
Publication of Reports	Under Companies Act every registered company is supposed to supply a copy of profit and loss account and balance sheet to the Registrar of the Companies at the end of A financial year. So, it is mandatory to publish final accounts of the company.	Management accounting reports are prepared the use of management only and these are not published.
Quickness of	Profit and loss account and	Different information are

reporting	balance sheet is prepared at the end of the year. So, the reporting of financial accounting is slow and time consuming.	required for taking managerial decisions and management is fed with reports at regular intervals. So, reporting of management accounting is very quick.
Audit	Under Company Act, auditing of financial accounting is compulsory.	Management accounting is based on projected data. So, it is not possible to get management accounts audited.

It is clear from the above discussion that financial accounts are based on actual historical data. Management accounting too uses historical data but the purpose is to use it for internal control, planning and policy formulation. The orientation of management accounting is more decision oriented in comparison to financial accounting.

2.5 Distinction between Cost Accounting and Management Accounting: The need for determination and control of costs necessitated the emergence of cost accounting as a special branch of accounting. Cost accounting and management accounting have the same objectives of helping the management in planning, policy formulation, control, evaluation of performance and decision making. Cost accounting and management accounting both are not statutory requirements. After going through the meaning and definitions of cost accounting and management accounting it is obvious that the distinction between the two is quite vague. Cost accounting and management accounting both are useful to the management and uses common tools and techniques like standard costing, marginal costing, differential costing and budgetary control etc. Some authors even consider the cost accounting and management accounting as synonyms terms. In this context the statement of a renowned author Horngren is very important. He says that, "Modern cost accounting is often called management accounting. Why? Because cost accountants look at their organization through manager's eye." In other words, it can be inferred that cost accounting has a managerial aspect which is not possible to separate from management accounting. For example, when a company takes decision regarding make or buy, selling below the cost price, entering into the foreign markets, it is related to cost accounting as well as management accounting.

On the basis of above discussion, it can be concluded that cost accounting and management accounting do not have clear cut boundaries. However, the distinction between cost accounting and management accounting is given below:

Point of Difference	Cost Accounting	Management Accounting
Objective	The objective of cost accounting is to record the cost so that the cost of a product or service can be determined	The objective of management accounting is to provide the information to the management such a way that is useful for planning, co-coordinating, decision making and control.
Scope	The scope of cost accounting s limited. Cost accounting only provides information related to costs.	Scope of Management accounting is broader than cost accounting. Management accounting provides all types of information, e.g. cost accounting as well as financial accounting information.
Nature	Cost accounting uses both past and present data. In cost accounting only quantitative aspect is considered.	Management accounting is mainly concerned with the projection of figures for the use in future. Management accounting uses both quantitative as well as qualitative information.
Status	The status of cost accountant comes after the management	Management accountant is senior in position to cost

	accountant.	accountant.
Assistance	Cost accounting merely assists the management in its functions.	Management accounting assists and evaluates the management performance.
Installation	Cost accounting system can be installed without management accounting	Management accounting needs financial accounting and cost accounting as its base for installation.
Evolution	The evolution of cost accounting is attributed to industrial revolution and due to limitation of financial accounting.	Management accounting has its origin during the last forty years because of limitations of financial accounting and cost accounting.
Principles	Certain principles and procedures are followed in cost accounting.	No certain principles and procedures are followed in management accounting.
Statutory Requirements	Maintenance of cost records has been made mandatory is selected industries as notified by the Govt. from time to time.	Management accounting is purely voluntary.
Emphasize	Cost accounting emphases on cost ascertainment, cost control etc.	Management accounting emphasis on planning, policy formulation, controlling, coordinating and decision making.
Techniques Employed	Tools and techniques of cost accounting include standard costing, variance analysis, marginal costing, budgetary control and uniform costing.	Management accounting also uses all the techniques of cost accounting but in addition to these techniques, it also uses techniques like ratio analysis,

		fund/cash flow analysis statistical analysis, various techniques of operations research, mathematics, macro economics, micro economics etc. which so ever can facilitate management in decision making.

2.6 SUMMARY

Management Accounting has been developed to facilitate the management for taking managerial decisions. The term ‘Management Accounting’ is of recent origin. The term was first used in 1950 by a team of accountants visiting U.S.A. under the auspices of Anglo-American Council on Productivity. Management accounting reproduces/ creates the accounting information in such a way that is helpful to the management in planning and policy formulation, control of execution and leads to more effectiveness. The evolution of Joint Stock Company has resulted in large-scale production and professionalism in business organization and management. In this scenario, the decision making no more remains a matter of intuition only, but requires the evolution of information system for helping management in taking managerial decisions. It may be concluded that management accounting uses all techniques of financial accounting, cost accounting and statistics to collect and process data for making it available to management so that it can take timely and correct decisions. Management Accounting is multi disciplinary in nature. For creating information to management, the management accountant uses different disciplines/areas of knowledge which constitute the scope of management accounting i.e. financial accounting, cost accounting, budgeting & forecasting, financial management, reporting to management, statistical tools, financial analysis and interpretation, control procedures and methods, tax accounting etc.

Financial accounting and management accounting are closely associated with each other and financial accounting provides a lot of information for management accounting to facilitate process of decision making. In a competitive business world, cost control and cost reduction are very important for the survival as well as growth in the business. There are many situations in which management accounting takes decision on the basis of cost information. For example, to make or buy decision, to enter in foreign markets or to sell lower the cost etc. management accountant uses the cost information. All these information are created by using marginal costing and standard costing methods. For the purpose of cost control, the standard costing and budgetary control are very helpful. In the end, it may be concluded that financial accounting, cost accounting and management accounting are closely associated with each other and are complimentary to each other.

2.7 KEY WORDS

Accounting Principles: Assumptions or postulates which are kept into onsideration while keeping financial accounts.

Financial Accounting: Branch of accounting in which at the end the two financial statements are prepared i.e. Income Statement and Balance Sheet.

Cost Accounting: Branch of accounting which is concerned with the determination of cost of products and services.

Management Accounting: Branch of accounting which makes the information available to the management which is directly useful for decision making.

Financial Management: A discipline which is concerned with the proper acquisition of funds and their proper utilization.

2.8 SELF ASSESSMENT QUESTIONS

Q.1. What is Management Accounting? Discuss the scope of Management accounting.

Q.2. How Management Accounting, Cost Accounting and Financial Accounting are related to each other?

Q.3. Distinguish between cost accounting and management accounting in detail.

Q.4. Distinguish between Financial Accounting and Management Accounting.

Q.5. Elaborate the reasons of emergence of Management Accounting in India**.**

2.9 SUGGESTED READINGS

1. Sharma, R.K. & Gupta, Shashi K., Management Accounting, Kalyani Publication, New Dlhi.

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Course: **Management Accounting**	
Course Code: **MC- 105**	Author: **Dr. Suresh K. Mittal**
Lesson No: **3**	Vetter: **Dr. Sanjay Tiwari**

MANAGEMENT ACCOUNTANT: ROLE, FUNCTIONS AND QUALIFICATIONS

STRUCTURE

3.0 OBJECTIVES

After going through this lesson, you should be able to:

- Know the role of Management Accountant in Organizations
- Know the functions and qualifications of Management Accountant
- Understand the limitations of Management Accountant

3.1 INTRODUCTION

Accountant is a person who performs the activities of accounting. The role of accounting is ever changing with the changes in economic and business development so the role of accountant is also changing day by day. The role of accountant as provider of historical description is no longer acceptable. In modern age, the role of accountant is very important which provides quantitative information about business operations to various parties who have directly or indirectly some stake in the business i.e. proprietor, creditors, investors, researchers, government and other agencies etc. The accountant finds out the profitability and financial position of the organization. For this purpose he prepares two financial statements i.e. Income Statement and Balance Sheet. The information provided by the accountant are very important but suffers from many limitations namely historical nature of data, provides information about the concern as a whole, cost control not possible, only actual costs are recorded, only quantitative information etc. Due to these limitations, management accounting came into existence and to overcome the limitations of Financial Accounting. The emergence of Management Accounting leads to a new profession which is called Management Accountant.

Management Accountant facilitates or provides the accounting information in such a way as to assist management in policy formulation, control of execution and effectiveness. A small undertaking does not require management accountant and generally managed by the owner himself. The owner is in touch with day to day working of the enterprise which plans and control the whole business himself, but in case of a Joint Stock Company, the decision making no more remains a matter of intuition and requires the evolution of effective information system for providing relevant information for taking managerial decisions. Therefore, the role and functions of management accountant are very important in modern business organizations. The main objective of management accountant is to provide accounting information required for facilitating managerial decision in business organizations.

3.2 ROLE OF MANAGEMENT ACCOUNTANT

The main role of management accountant in modern business organizations is to provide accounting information at various levels of management so that effective decision can be taken in the organization. In addition to this, the following roles of management accountant are discussed below:

8. **Role in establishing cause and effect relationship:** Management accountant tries to establish the cause and effect relationship between different variables which is very helpful in decision making. For example, if there is decrease in sales, he/she tries to know how much the profit will be affected due to decrease in sales.
9. **Role in Planning and policy formulation:** Management accountant plays very important role in planning and policy formulation in business organizations. Management accountant predicts about the future by using different techniques such as budgetary control, standard costing etc. All these information supplied and opinion given by the management accountant helps in planning and policy formulation in business organizations.
10. **Role in Organizing of Business Activities:** Management accountant plays a very important role in organizing the activities of the organization by using the delegation of authority and fixing of responsibility. Management accountant also plays important role in establishing of cost centers, preparation of budgets etc. which is really helpful in organizing the business organizations.
11. **Role in Co-Ordination:** Management accountant plays an important role in co-ordination of different activities of the organization. For example, while preparing purchase budget, production budget, sales budget, labor budget, material budget, overhead budget etc., he/she also prepares a master budget which helps in coordinating between different budgets and in this way helps in co-coordinating the different activities of the organizations.
12. **Role in controlling:** Management accountant plays a very important role in controlling of different activities of the organization. The main controlling techniques

used by the management accountants are standard costing and budgetary control. Through these techniques the actual performance is compared with standard performance and if there is any deviation between the two, corrective actions are taken so that planned performance and actual performance are in tune with each other.

13. **Role in communication:** Management accountant plays a very important role in keeping the management fully informed about the latest position of the business for which he/she uses various techniques of analysis and interpretation of financial statements so that technical nature of financial information can be converted into simple language. The information provided by the management accountant is very useful for the management in taking timely and right decisions.
14. **Role in qualitative information:** Management accountant plays a very important role in providing qualitative information to the management and sometimes qualitative information is more important than quantitative information.
15. **Role in tax administration:** Management accountant plays a very important role in tax administration. Management accountant helps in assessing various tax liabilities and depositing correct amount of taxes with the authorities which avoids the penalties and enhances the goodwill of the organization.

3.3 FUNCTIONS OF MANAGEMENT ACCOUNTANT

The main function of management accountant is to provide information to the management/owners in such a way that it is helpful to the management in running and controlling the organization in an efficient and economical manner. For providing information to the management, the management accountant performs different functions. Some of the functions of management accountant are discussed below:

9. **Forecasting and Planning:** Forecasting and planning are the important functions of management accountant. The management accountant uses various techniques such as budgeting, standard costing, marginal costing, and ratio analysis which are useful in forecasting and planning activities of a firm. The techniques used by management accountant are very useful in forecasting and planning which are instrumental in achieving the targets of the organization.

10. **Modification of data:** Management accountant helps in modifying accounting data in such a way that it is very useful to the management. For example if cost data is required, the management accountant classifies the cost data as material cost, labor cost, overhead cost, avoidable cost, fixed cost, variable cost etc. which may be very useful to the management. Hence, the function of management accountant is to classify and modify the data according to the requirement of the management.
11. **Financial Analysis and Interpretation:** Management accountant carries out functions of analysis and interpretation of financial statements. Management accountant compares the different values which are related and make interpretation of the analysis. For example, profits are related to sales and capital employed, but financial statements such as Income Statement and Balance Sheet provide only absolute value and the decision is taken on the relative value. There is need of analysis and interpretation of financial statements which is done by the management accountant.
12. **Facilitates Managerial Control:** Management accountant facilitates in controlling performance in the business organizations. The management accountant uses standard costing and budgetary control for controlling of business organizations. Management accountant compares the actual performance with the standard/ budgeted performance and deviations are calculated. It enables the management to take corrective actions which helps in managerial control.
13. **Communication:** Communication is very important function within the organization and with the outside world which is performed by the management accountant. For this purpose, the management accountant prepares various reports for the use of different levels of management, employees and communicated to the outsiders, too.
14. **Qualitative Information:** The Management accountant provides various kinds of qualitative information to the management which are very important for the management for taking managerial decisions. The qualitative information provided by the management accountant includes; internal control, performance related, responsibility centers and overall managerial performance.

15. **Co-Ordination:** Management accountant helps in coordinating among different departments of the organization. The plans and performances of different departments are communicated to the management, so that management is in position to co-ordinate different activities. Master budget is very important tool in the hands of management accountant to co-ordinate the different budgets.
16. **Helpful in taking strategic decisions:** Management accountant helps in taking strategic decisions like replacement decision, expansion, diversification, make or buy decision, to enter in foreign markets etc. For this purpose the management accountant uses different techniques like marginal costing, differential costing etc.

3.4 TOOLS/TECHNIQUES USED BY MANAGEMENT ACCOUNTANT

Management accountant generally uses a number of tools and techniques to help management in taking managerial decision which helps in achieving business goals. Some of the important tools and techniques are mentioned below:

20. Financial Accounting and Policy
21. Analysis of Financial Statements
22. Historical Cost Accounting
23. Standard Costing and Variance Analysis
24. Marginal Costing and Cost-Volume Profit Analysis
25. Differential Cost Analysis
26. Cash Flow Statement
27. Funds Flow Statement
28. Revaluation Accounting
29. Budgetary Control
30. Responsibility Accounting
31. Accounting for Price level Changes
32. Life Cycle Costing
33. Value Analysis
34. Management Information System
35. Activity Based Costing
36. Total Quality Management

37. Target Costing

38. Inventory Control

3.5 PERQUISITES FOR BECOMING A MANAGEMENT ACCOUNTANT:

I. Knowledge of management, commerce, tax, audit, accounting, economics, business law company law etc.

II. Possess adequate degree/professional qualification.

III. Updated with the latest changes in business law and management.

IV. Should possess analytical and communication skills so as to facilitate and convince management

V. Computer savvy and IT awareness are must for management accountant.

3.6 IMPORTANCE OF MANAGEMENT ACCOUNTANT

The role and importance of management accountant is increasing day by day due to increasing complexity of business world, large scale of operation, globalised business trends and usage of technology in business. The importance of management accountant in business organizations are discussed as below:

7. **Increase in efficiency:** Management accountant play a very important role in increasing the efficiency of business operations. The management accountant fixes the targets of every department in advance and achievements of these targets are judged by management accountant by using a tool of measuring their efficiency which helps in increasing the overall efficiency of the organizations.
8. **Cost control and cost reduction:** The technique used by management accountant such as standard costing and budgeting helps the management to reduce and control the cost. The cost reduction helps in increasing the sales of the organization which helps in increasing the profitability of the organization.
9. **Effective Decision Making:** Management accountant helps in effective decision making by providing right and timely information to the management. The management accountant converts or creates the accounting information which is directly helpful for taking effective decisions. For example, when profits are

compared with sales volume and capital employed then provides more relevant information to the management which results in effective decision making.

10. **Helpful in management control:** The management accountant plays a very important role in management control. Management accountant uses different tools and techniques of management accounting which are helpful to the management in planning, coordinating and controlling activities of the organization. For example with the help of standard costing and budgetary control the management is able to know why actual performance do not match with budgeted/standard performance and suggests corrective action so that budgeted performance and actual performance are in synchronization.

3.7 LIMITATIONS OR SCOPE OF MANAGEMENT ACCOUNTANT

The role and importance of management accountant is increasing day by day in business organizations due to increasing complexity of business organizations, large scale of operation, globalised business, and corporatization of business, competition and role of technology in business. The main function of management accountant is to provide information to the management/owners in such a way that it is helpful to the management in operating and controlling the organization in an efficient and effective manner. But the information provided by management accountants suffers from a lot of limitations which are discussed below:

8. **Based on accounting information**: Management accountant provides the information to the management and the information provided by the management accountant are based on the data supplied by financial and cost accounting. The effectiveness of management accountant depends on the accuracy and reliability of the accounting data. The financial accounting information is based on some assumptions and conventions; hence there are chances of lack of reliability.
9. **No role in decision making:** The use of information provided by management accountant requires the knowledge of a number of subject/issues like accounting, statistics, economics, taxation, production etc. but the person who is taking the

final decisions may not have good knowledge of these subjects/disciplines as management accountant can only provide information and cannot take decisions.

10. **Culture of Taking Intuitive Decision:** It has been observed that management ignores lengthy and qualitative information provided by management accountant while taking decisions. The management prefers the decision on intuition based which limits the usefulness of management accountant in business organizations.
11. **No Substitute of administration:** The management accountant provides only information and not decisions and the decision are taken by the management. So, management accounting has supplementary/supportive services role and has no final say in taking decisions.
12. **Lack of Proper Management Accounting System:** The proper installation of management accounting system in a firm requires large organizational structure which requires a lot of funds. The business organizations generally do not install proper system and do not hire competent professional which is a big problem for the management accountant.
13. **Psychological Resistance:** The installation of management accounting system in organization requires a lot of changes in organization structure, rule and regulations. There changes are resisted by the management and employees of the organization which becomes a major hurdle for a management accountant.

3.8 SUMMARY

Accountant is a person who performs the activities of accounting. The role of accountant as provider of historical description of business data is no longer acceptable. In modern age, the role of accountant is very important which provides quantitative information about business operations to various stakeholders who have directly or indirectly some stake in the business i.e. proprietor, creditors, investors, researchers, government and other agencies etc. The accountant judges/gauges financial performance such as profitability and financial position of an organization. For this purpose, he/she prepares two financial statements i.e. Income statement and Balance Sheet. The information provided by accountant are very important but suffers from many limitations namely historical nature of data, holistic information, cost control not possible, only actual costs are recorded, only quantitative information etc. Due to these limitations the Management Accounting came into existence and overcome the limitations of Financial Accounting. The emergence of Management Accounting led to a new profession which is called Management Accountant.

The Management Accountant facilitates or provides the accounting information in such a way as to assist management in policy formulation, control of execution and effectiveness. A small undertaking does not require management accountant and generally managed by the owner himself. The owner is in touch with day to day working of the enterprise and plans and control the whole business himself. But in case of Joint Stock Companies and bigger organization, the decision making no more remains a matter of intuition and requires the evolution of effective information system for providing relevant information for taking managerial decisions. Hence the role and functions of management accountant are very important in modern business organizations. The main objective of management accountant is to provide accounting information required for taking managerial decision in business organizations. The role of management accountant is to establish cause and effect relationship, planning and policy formulation, organizing of business activities, co-ordination, controlling, communication and tax administration in organization etc. Basically they are required for internal control.

The main function of management accountant is to provide information to the management/owners in such a way that it is helpful to the management in running and controlling the organization in an efficient and effective manner. The management accountant performs the functions like forecasting and planning, modification of data, financial analysis and interpretation, managerial control, communication, co-ordination and helpful in taking strategic decisions. The management accountant should have the knowledge of various tools and techniques of management accounting namely financial accounting, cost accounting, management accounting etc. The management accountant has a very important role in increasing the efficiency, cost control and cost reduction, effective decision making and managerial control. The management accountant suffers from many limitations like information provided by management accountant are based on accounting information, no role in decision making, culture of taking intuitive decisions, no substitute of administration, lack of proper management accounting system and suffers from psychological resistance etc.

3.9 KEY WORDS

Marginal Costing: A technique of costing in which only variable costs are considered.

Standard Costing: The technique of using standard costs for the purpose of cost control.

Management Accounting: the branch of accounting which deals with facilitating the process of decision making.

Management accountant: The professionals who provide the business data in such a way so as to facilitate decision making.

Budgetary Control: A system which uses budgets as a mean of planning and controlling.

Master Budget: A budget in which various functional budgets are integrated.

Cost Centre: A part of an organization to which costs may be charged for accounting purpose.

3.10 SELF ASSESSMENT QUESTIONS

Q.1. What do you mean by Management Accountant? Discuss the role of management accountant in business organizations.

Q. 2. Discuss the functions of Management Accountant.

Q. 3. Write a detailed note on qualifications of Management Accountant.

Q. 4. Give an overview of importance of Management Accountant in a company organization.

Q. 5. Explain the limitations/ scope of Management Accountant in detail.

3.11 SUGGESTED READINGS

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Course: **Management Accounting**	
Course Code: **MC- 105**	Author: **Dr. Suresh K. Mittal**
Lesson No: **5**	Vetter: **Dr. Sanjay Tiwari**

TOOLS OF FINANCIAL STATEMENT ANALYSIS: TREND, PERCENTAGE AND INTER-FIRM COMPARISON

STRUCTURE

5.0 OBJECTIVES

After going through this lesson, you should be able to:

- Know the meaning and types of analysis of financial statements.
- Understand the various tools of financial statement analysis.
- Know the inter-firm comparison.
- Understand the limitations of financial statement analysis.

5.1 INTRODUCTION

Accounting is mainly concerned with recording business transactions in the books of account for the purpose of presenting final accounts. The information supplied by accounting is summarized in the following two statements at the end of the accounting period, which may be financial year or calendar year:

i) Income Statement: The income statement shows the profit or courses during the period.

ii) Balance Sheet: It is a statement showing the financial position of the firm at a point of time.

The external parties such as shareholders, creditors, employees, potential investors, govt. agencies etc. are able to get information regarding business with the help of these two statements.

The financial statements mentioned above provide a summary of the accounts of a business firm. The information given in the financial statements are the result of the combined effect of the following:

i) Recorded Facts

ii) Accounting Concepts and Conventions

iii) Personal Judgments

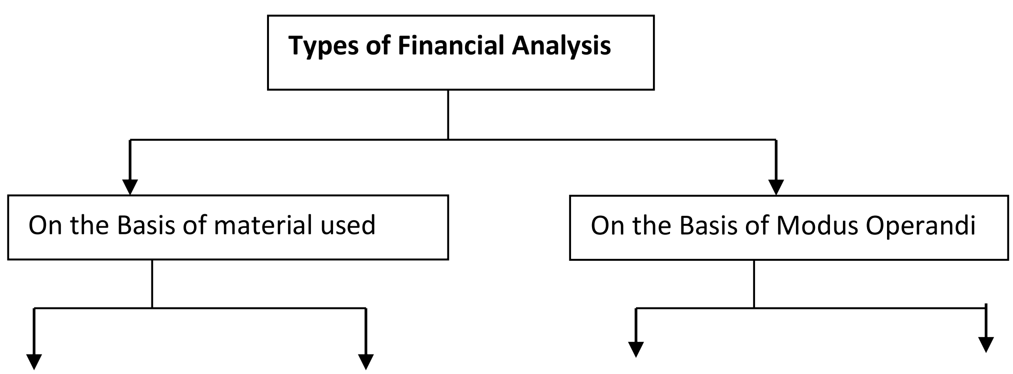
The financial statements i.e. income statement and balance sheet show the financial position for the accounting period. The financial statements do not mention/explain the reason why the financial position changes from one period to another period. Therefore, to remove the limitation of financial statements, there is a need of analysis of financial statements. The data available in financial statements i.e. trading and Profit & Loss Account and Balance Sheet are very important and this data can be converted into information through analysis and interpretation of financial statements.

5.2 MEANING AND CONCEPT OF FINANCIAL ANALYSIS

The term Financial Analysis refers to the process of determining financial strengths and weaknesses of a organization by establishing the relationship between the items of the Balance Sheet and Income Statement. In other words, the financial statement analysis may be defined as the study of relationship between the various financial items in a business. There is some logical relationship between the different financial items for example profits are highly related with sales volume and capital employed in the business. So, if we analyze the amount of profits in relation to sales or capital employed, meaningful conclusion can be drawn. The main objective of analysis of financial statements is to judge the profitability and financial position of the firm. The financial data given in the financial statements is the result of recorded facts, accounting principles and personal judgments of the accountant. The analysis of financial statements is essential to bring out the mystery behind the financial data in the financial statements. Analysis of financial statements is very important to present the data or to understand the data in such a way which is more useful for decision making for example if the profit of a company are in crores, by analyzing this data will be converted into single or double digits which is very meaningful, convenient and useful for decision making. The term 'analysis' and 'interpretation' are used inter-changeably but the distinction should be made between the two terms. The term analysis mean the simplification of financial data by classification of data and the term interpretation means explaining the meaning and significance of data so simplified. Both the terms analysis and interpretation are linked and complimentary to each other. Analysis is useless without interpretation and interpretation without analysis is impossible. Generally, the term financial statement Analysis or Financial Analysis is used to cover the meaning of both analysis and interpretation.

5.3 TYPES OF FINANCIAL ANALYSIS

There may be different types of financial analysis depending upon the material used, method of operation or modus operandi of analysis. The detail of types of financial analysis is given below:



External Analysis	Internal Analysis	Horizontal Analysis	Vertical Analysis

(i) On The Basis **Of Material Used:** According to material used, financial analysis can be of two types: (a) external analysis, and (b) internal analysis.

(a) External Analysis. This analysis is done by outsiders who do not have access to accounting records of the business firm. These outsiders include investors, potential investors, creditors, potential creditors, government agencies, credit agencies, and the general public. For financial analysis, these external parties to the firm depend almost entirely on the published financial statements.

(b) Internal Analysis: The analysis conducted by persons who have access to the internal accounting records of a business firm is known as internal analysis. Such an analysis can, therefore, be performed by managers and employees of the organization as well as government agencies which have statutory powers. Financial analysis for managerial purposes is the internal type of analysis that can be affected depending upon the purpose to be achieved.

(ii) On The Basis Of Modus Operandi: According to the method of operation followed in the analysis, financial analysis can also be of two types: (a) horizontal analysis and (b) vertical analysis.

(a) Horizontal Analysis: Horizontal analysis refers to the comparison of financial data of a company for several years. The figures for this type of analysis are presented horizontally over a number of columns. The figures of the various years are compared with base year. This type of analysis is also called "Dynamic Analysis' as it is based on the data from year to year rather than on data of any one year. The horizontal analysis makes it possible to focus attention on items that have changed significantly during the period under review. Comparison of an item over several periods with a base year may show a trend emerging. Comparative statements and trend percentages are two tools employed in horizontal analysis.

(b) Vertical Analysis: Vertical analysis refers to the study of relationship of the various items in the financial statements of one accounting period. In this type of analysis the figures from financial statement of a year are compared with a base selected from the same year's statement. It is also known as 'Static Analysis' Common-size financial statements and financial ratios are the two tools employed in vertical analysis.

Procedure of Financial Statement Analysis:

There are three steps involved in the analysis of financial statements which are mentioned below:

(i) Selection of financial data.

(ii) Classification of data

(iii) Interpretation of data

The following procedure should be adopted in the analysis and interpretation of financial statements:

(1) The analyst must acquaint himself with the accounting concepts, conventions and postulates. If the analyst not properly acquaint with the accounting, he will not be able to understand the mystery behind the accounting data which is available in the financial statements.

(2) The scope of the analysis should be determined which generally depends on the objectives of the analysis so that the levels of analysis may be determined. If the profit

ability of the enterprise is to be determined, the income statement will be undertaken. On the other hand, liquidity position and solvency position is to be studied then Balance Sheet will be undertaken.

(3) The Financial data given in the statements should be re-organised/re-arranged i.e. grouping of similar data under same heads etc.

(4) A relationship between the different kinds of financial data should be established with the help of tools of analysis. For example current assets should be compared with current liabilities, profits should be compared with the sales as well as capital employed so that meaningful conclusion can be drawn.

(5) The information which is created through the analysis of financial statements should be interpreted in a simple and understandable way so that it can be more useful.

(6) After analyzing the financial statements, the analyst interprets the results then these results should be used in drawing conclusions which should be presented to the management in the form of reports.

5.4 METHODS OR DEVICES OF FINANCIAL ANALYSIS

The analysis and interpretation of financial statements is used to determine the financial position and results of the operations. Before using the methods or devices of analysis of financial statements, it is necessary and useful that figures should be arranged properly. The financial statements should be prepared in single (vertical) column form which should throw up significant figures by adding or substracting. This format will also facilitate showing the figures of a number of firms or number of years side by side the comparison purposes. The performa of this format is given below:

Income Statement for the Year Ending………

PARTICULARS				
	Gross Sales			
Less:	Sales Returns			
	Sales Tax/Excise			
	Net Sales (or sales) for the year	(1)		
Less:	Cost of Sales: (2)			
	Raw Materials consumed			
	Direct Wages			
	Manufacturing Expenses			
Add:	Opening Stock of Finished Goods			
Less:	Closing Stock of Finished Goods			
	Gross Profit	(1) – (2) = (3)		
Less:	Operating Expenses:			
	Administration Expenses			
	Selling and Distribution Expenses			
	Net Operating Profit (OPBIT)	(3) – (4) = (5)		
Add.	Non-trading Income			
	(such as dividends, interest received, etc.)			
Less:	Non-trading Expenses (such as discount on			
	Issues of shares written off)			
	Income or Earning before Interest and Tax (EBIT)	(6)		
Less:	Interest on Debentures	(7)		
	Net Income or Earning before Tax (EBT)	(8)		
Less:	Tax	(9)		
	Income or Profit After Tax (PAT)	(10)		

Balance Sheet as on …………….

PARTICULARS			
Cash in Hand			
Cash at Bank			

Bills Receivable			
Books Debts (less provision for bad debts)			
Marketable Trade Investments			
Liquid Assets	(1)		
Inventories (stock of raw materials, finished goods, etc.)			
Prepaid Expenses			
Current Assets	(2)		
Bills Payable			
Trade Creditors			

PARTICULARS			`
Outstanding Expenses			
Bank Overdraft			
Other Liabilities Payable within a year			
Current Liabilities	(3)		
Provision for Tax			
Proposed Dividends			
Other Provisions	(4)		
Provisions			
Current Liabilities and Provisions	(3) + (4) = (5)		
Net Working Capital			
[Current Assets – Current Liabilities and Provisions	(2) – (5)] = (6)		
Goodwill at cost*			
Land and Building			
Plant and Machinery			
Loose Tools			
Furniture and Fixtures			
Investments in Subsidiaries			
Patents, Copyright, etc.			
Fixed Assets:	(7)		
Capital Employed	(6) + (7) = (8)		
Other Assets:	(9)		
Investment in Government Securities, Unquoted Investments, etc.			
Other Investments (non-trading)			

Advances to Directors			
Company's Net Assets	(8) + (9) = (10)		
Debentures			
Other Long-term Loans (payable after a year)			
Long-term Loans	(11)		
Shareholders' Net Worth	(10) – (11) = (12)		
Preference Share Capital	(13)		
Equity Shareholders' Net Worth	(12) – (13) = (14)		
Equity Shareholders' Net Worth is represented by:	….		
Equity Share Capital			
Forfeited Shares			
Reserves			
Surplus			
Equity Shareholders's Claims			
Less: Accumulated Losses	…		
Miscellaneous Expenditure	…		
(such as preliminary expenses, discount on issue of shares			
or debentures not written off)	…		
Equity Shareholders' Net Worth			

After converting the data into the format given above, the methods of financial analysis are used. Some of the methods of financial of annual statements are given below:

(i) Trend Analysis

(ii) Comparative Statements

(iii) Common-size Statements.

5.5. TREND ANALYSIS

The information for a number of years is taken up one year, generally the first year, is taken as a base year. The figures of the base year are taken as 100 and trend ratios for other years are calculated on the basis of base year. The analyst is able to see the trend of figures, whether upward or downward. For example, if sales figures for the year 2012 to 2017 are to be studied, then sales of 2012 will be taken as 100 and the percentage of sales for all other years will be calculated in relation to the base year, i.e. 2012. Suppose the following trends are determined.

2012	100
2013	120
2014	110
2015	125
2016	135
2017	140

The trends of sales show that sales have been more in all the years since 2012. The sales have shown an upward trend except in 2014 when sales were less than the previous year i.e. 2013. Trends shows that rate of increase in sales is less in the years 2016 and 2017. The increase in sales is 15% in 2015 as compared to 2014 and increase in 10% in 2016 as compared to 2015 and 5% in 2017 as compared to 2016. Though the sales are more as compared to the base year but still the rate of increase has not been constant and requires a study by comparing these trends to other items like cost of production, etc.

Requirements for Calculating Trends

(1) One year is taken as a base year. Generally, the first is taken as base year.

(2) The figures of base year are taken as 100.

(3) Trend percentages are calculated in relation to base year. If a figure in other year is less than the figure in base year the trend percentage will be less than 100 and it will be more than 100 if figure is more than base year figure. Each year’s figure is divided by the base year’s figure.

The base period should be carefully selected. The base period should be a normal period. The price level changes in subsequent years may reduce the utility of trend ratios. If the figure of the base-period is very small, then the ratios calculated on this basis may not give a true idea about the financial data. The accounting procedures and conventions used for collecting data and preparation of financial statements should be similar, otherwise the figures will not be comparable.

Illustration**:** Calculate the trend percentages from the following figures of X Ltd. Taking 2013 as the base and interpret them:

			(Rs. in lakhs)
Year	**Sales**	**Stock**	**Profit before tax**
2013	1,881	709	321
2014	2,340	781	435
2015	2,655	816	458
2016	3,021	944	527
2017	3,768	1,154	672

Solution:

TRENDPERCENTAGES
(Base Year 1989 = 100)

Year	**Sales**		**Stock**		**Profit before tax**	
	Amount (Rs. Lakhs)	**Trend Percentage**	**Amount (Rs. Lakhs)**	**Trend Percentages**	**Amount Rs.**	**Trend Percentages**
2013	1,881	100	709	100	321	100
2014	2,340	124	781	110	435	136
2015	2,655	141	816	115	458	143
2016	3,021	161	944	133	527	164
2017	3,768	200	1,154	162	672	209

(1) The sales have continuously increased in all the years up to 2017. The increase in sales is quite satisfactory.

(2) The figures of stock have also increased from 2013 to 2017. The increase in stocks is more in 2016 and 2017 as compared to earlier years.

(3) Profit before tax has substantially increased. In five years period it has more than doubled.

The expansion of the firm is good and it has doubled its sales and profits in just five years time. The profits have increases more than sales which shows that there is a proper control over cost of goods sold, the overall performance of the concern is good.

5.6 PERCENTAGE METHOD OF ANALYSIS (COMPARATIVE STATEMENTS)

The comparative financial statements show the financial position of a concern for different periods of time. Generally, Balance Sheet and Income Statement are prepared in comparative form. The analyst is able to draw meaning information when data is given in a comparative position. The one point should be kept in mind while preparing comparative statements that accounting principles used in preparing these statements should be same. If there is any changes in accounting procedure or methods the analyst should be careful in using these statements:

The two comparative statements are:

(i) Balance Sheet (ii) Income Statement

(i) Comparative Balance Sheet: The trends of the same item, group of items in two are more than two balance sheets of the same firm on different dates is prepared. The objectives of preparing the comparative Balance Sheet are given below:

- Change in current financial position and liquidity position in comparison to previous period.
- Change in long term financial position of the term in comparison to previous period.
- Change in profitability position of the firm in comparison to previous period.

After studying the current assets, current liabilities, fixed assets, long term assets, an opinion should be formed about the financial position of the concern.

Illustration: The following are the Balance Sheets of a concern for the years 2016 and 2017. Prepare a Comparative Balance Sheet and study the Financial position of the concern.

BALANCE SHEET

As on 31st December

Liabilities	2016 Rs.	2017 Rs.	Assets	2016 Rs.	2017 Rs.
Equity Share Capital	6,00,000	8,00,000	Land & Buildings	3,70,000	2,70,000
Reserves & Surplus	3,30,000	2,22,000	Plant & Machinery	4,00,000	6,00,000
Debentures	2,00,000	3,00,000	Furniture & Fixtures	20,000	25,000
Long-term loans On Mortgage	1,50,000	2,00,000	Other fixed Assets	25,000	30,000
Bills Payable	50,000	45,000	Cash in hand and at bank	20,000	80,000
Sundry Creditors	1,00,000	1,20,000	Bills Receivables	1,50,000	90,000
Other Current Liabilities	5,000	10,000	Sundry Debtors	2,00,000	2,50,000
			Stock	2,50,000	3,50,000
			Prepaid Expenses		2,000
	14,35,000	16,97,000		14,35,000	16,97,000

Solution:

COMPARATIVE BALANCE SHEET OF A COMPANY for the year ending December 31, 2016 and 2017			
	Year ending 31 December	Increase/Decrease (Amounts)	Increase/Decrease (Percent ages)

Assets	2016	2017		
	Rs.		Rs.	Rs.
Current Assets:				
Cash in hand and at Bank	20,000	80,000	-60,000	+300
Bills Receivables	1,50,000	90,000	–60,000	–40
Sundry Debtors	2,00,000	2,50,000	+50,000	+25
Stock	2,50,000	3,50,000	+1,00,000	+40
Prepaid Expenses	–	2,000	+2,000	
Total Current Assets	6,20,000	7,72,000	+1,52,000	+24.52
Fixed Assets:				
Land & Buildings	3,70,000	2,70,000	–1,00,000	–27.03
Plant & Machinery	4,00,000	6,00,000	+2,00,000	+50.00
Furniture & Fixtures	20,000	25,000	+5,000	25.00
Other Fixed Assets	25,000	30,000	+5,000	20.00
Total Fixed Assets	8,15,000	9,25,000	+1,10,000	+13.49
Total Assets	14,35,000	16,97,000	+2,62,000	+18.26

Liabilities & Capital	Year ending 31 December		Increase/Decrease (Amounts)	Increase/Decrease (Percent ages)
	2016	2017		
	Rs.		Rs.	Rs.
Current Liabilities				
Bills Payable	50,000	45,000	–5,000	–10
Sundry creditors	1,00,000	1,20,000	+20,000	+20
Other current liabilities	5,000	10,000	+5,000	+100

Total Current Liabilities	1,55,000	1,75,000	+20,000	+12.9
Debentures	2,00,000	3,00,000	+1,00,000	+50
Long-term loans or Mortgage	1,50,000	2,00,000	+50,000	+33
Total Liabilities	5,05,000	6,75,000	+1,70,000	+33.66
Equity Share Capital	6,00,000	8,00,000	+2,00,000	+33
Reserve & Surpulses	3,30,000	2,22,000	+1,08,000	-32.73
Total	14,35,000	16,97,000	+2,62,000	+18.26

Interpretation

(1) The comparative balance sheet of the company reveals that during 2017 there has been an increase in fixed assets of 1,10,000 i.e. 13.49% while long-term liabilities to outsiders have relatively increased by Rs. 1,50,000 and equity share capital has increased by Rs. 2 lakhs. This fact depicts that the policy of the company is to purchase fixed assets from the long-term sources of finance thereby not affecting the working capital.

(2) The current assets have increased by Rs. 1,52,000 i.e. 24.52% and cash has increased by Rs. 60,000. On the other hand, there has been an increase in inventories amounting to Rs. 1 lakh. The Current liabilities have increased only by Rs. 20,000 i.e. 12.9%. This further confirms that the company has raised long-term finances even for the current assets resulting into an improvement in the liquidity position of the company.

(3) Reserves and surpluses have decreased from Rs. 3,30,000 to Rs. 2,22,000 i.e., 32.73% which shows that the company has utilised reserves and surpluses for the payment of dividends to shareholders either in cash or by the issue of bonus shares.

(4) The overall financial position of the company is satisfactory.

(ii) Comparative Income Statement

The Income statement gives the results of the operations of a business. The comparative income statement gives an idea of the progress of a business over a period of time. The changes in absolute data in money values and percentages can be determined to analyse the profitability of the business. Like comparative balance sheet, income statement also has four columns. First two columns give figures to various items for two years. Third and fourth columns are used to show increase or decrease in figures in absolute amounts and percentages respectively.

Illustration : The income statements of a concern are given for the year ending on 31st Dec. 2016 and 2017. Re-arrange the figures in a comparative form and study the profitability position of the concern.

	2016	2017
	Rs. (000)	Rs. (000)
Net Sales	785	900
Cost of goods sold	450	500
Operating Expenses:		
General and administrative expenses	70	72
Selling expenses	80	90
Non-operating Expenses:		
Interest paid	25	30
Income-tax	70	80

Solution:

COMPARATIVE INCOME STATEMENT for the year ended 31st Dec. 2016 and 2017				
	31 December		Increase (+) Decrease(-) Rs.(000)	Increase (+) Decrease(-) (Percentages)
	2016	2017		

Decrease (–)	Rs. (000)	Rs. (000)		Rs.
Net Sales	785	900	+115	+14.65
Less: Cost of goods sold	450	500	+50	+11.0
Gross Profit	335	400	+65	+19.40
Operating Expenses:				
General & Administrative				
Expenses	70	72	+2	+2.8
Selling Expenses	80	90	+10	+12.5
Total Operating Expenses	150	162	+12	+8.0
Operating Profit	185	238	+53	+28.65
Less: Other deductions Interest paid	25	30	+5	+20
Net Profit before tax	160	208	+48	+30.0
Less: Income tax	70	80	+10	+14.3
Net Profit after tax	90	128	+38	+42.22

Interpretation

The comparative income statement given above reveals that there has been an increase in net sales of 14.65% while the cost of goods sold has increased nearly by 11% thereby resulting in an increase in the gross profit of 19.4%. Although the operating expenses have increased by 8% the increase in gross profit is sufficient to compensate for the increase in operating expenses and hence there has been an overall increase in operational profits amounting to Rs. 53,000 i.e. 28.65% in spite of an increase in financial expenses of Rs. 5,000 for interest and Rs. 10,000 for income tax. There an increase in net profits after tax amounting to Rs. 38,000 i.e. 42.22%. It may be concluded that there is a sufficient progress in the company and the overall profitability of the company is good.

5.7. INTER-FIRM COMPARISON (COMMON-SIZE STATEMENT)

The Common-size statements, balance sheet and income statement are shown in analytical percentages. The figures are shown as percentages of total assets, total liabilities and total sales. The total assets are taken as 100 and different assets are expressed as a percentage of the total. Similarly, various liabilities are taken as a part of total liabilities. These statements are also known as component percentage or 100 percent statements because every individual item is stated as a percentage of the total 100. The short-comings in comparative statements and trend percentages where changes in items could not be compared with the totals have been covered up. The analyst is able to assess the figures in relation to total values. The common-size statements may be prepared in the following way:

(1) The totals of assets or liabilities are taken as 100.

(2) The individual assets are expressed as a percentage of total assets, i.e. 100 and different liabilities are calculated in relation to total liabilities. For example, if total assets are Rs. 5 lakhs and inventory value is Rs. 50,000, then it will be 10% of the total assets $\left(\frac{50{,}000 \text{ x}100}{5{,}00{,}000}\right)$

(i) Common-Size Balance Sheet

A statement in which balance sheet items are expressed as the ratio of each asset to total assets and the ratio of each liability is expressed as a ratio of total liabilities is called common-size balance sheet. For example, following assets are shown in a common-size balance sheet:

	Rs.	Percentage
Cash in hand and at bank	5,000	2,50
Sundry debtors	20,000	10,00

Stock	25,000	12.50
Land and Buildings	50,000	25.00
Plant and Machinery	1,00,000	50.00
Total Assets:	2,00,000	100.00

The total figure of assets Rs. 2,00,000 is taken as 100 and all other assets are expressed as a percentage of total assets. The relation of each asset to total assets is expressed in the statement. The relation of each liability to total liabilities is similarly expressed.

The common-size balance sheet can be used to compare companies of differing size. The comparison of figures in different periods is not useful because total figures may be affected by a number of factors. It is not possible to establish standard norms for various assets. The trends of figures from year to year may not be studied and even they may not give proper results.

Illustration: The balance sheet of S & Co. and K & Co. are given as follows:

BALANCE SHEET
As on Dec. 31, 2017

Liabilities	**S & Co.**	**K & Co.**
	Rs.	**Rs.**
Preference Share Capital	1,20,000	1,60,000
Equity Share Capital	1,50,000	4,00,000
Reserve & Surpluses	14,000	18,000
Long-term loans	1,15,000	1,30,000,
Bills payable	2,000	-
Sundry Creditors	12,000	4,000
Outstanding Expenses	15,000	6,000
Proposed dividend	10,000	90,000
	4,38,000	8,08,000

Land and Building	80,000	1,23,000
Plant and Machinery	3,34,000	6,00,000
Temporary Investment	1,000	40,000
Inventories	10,000	25,000
Book-Debts	4,000	8,000
Prepaid Expenses	1,000	2,000
Cash and Blank Balances	8,000	10,000
	4,38,000	8,08,000

Compare the financial position of two companies with the help of common size balance sheet.

COMMON-SIZE BALANCE SHEET

As on Dec. 31, 2017

	S & Co.		K & Co.	
Assets	Amount (Rs.)	%	Amount (Rs.)	%
Fixed Assets				
Land and building	80,000	18.26	1,23,000	15.22
Plant and machinery	3,34,000	76.26	6,00,000	74.62
Total Fixed Assets	4,14,000	94.52	7,23,000	89,48
Current Assets				
Temporary Investments	1,000	0.23	40,000	4.95
Investories	10,000	2.28	25,000	3,08
Book Debts	4,000	0.91	8,000	0.99
Prepaid Expenses	1,000	0.23	2,000	0.25
Cash and Bank Balance	8,000	1.83	10,000	1.25
Total Current Assets	24,000	5.48	85,000	10.52
Total Assets	4,38,000	100,00	8,08,000	100.00
Share Capital and Reserves				
Preference Share Capital	1,20,000	27.39	1,60,000	19,80
Equity Share Capital	1,50,000	34.25	4,00,000	49.50

Reserves and Surpluses	14,000	3.19	18,000	2.23
Total Capital & Reserves	2,84,000	64.83	5,78,000	71.53
Long-term Loans	1,15,000	26,25	1,30,000	16.09
Current Liabilities				
Bills Payable	2,000	0.46	–	–
Sundry Creditors	12,000	2.74	4,000	0.49
Outstanding Expenses	15,000	3.44	6,000	0.74
Proposed Dividend	10,000	2.28	90,000	11.15
	39,000	8.92	1,00,000	12.38
Total of Liability Side	4,38,000	100.00	8,08,000	100.00

Comments:

(1) An analysis of pattern of financing of both the companies shows that K & Co. is more traditionally financed as compared to S& Co. The former company has depended more on its own funds as is shown by balance sheet.

(2) Both the companies are suffering from inadequacy of working capital. The percentage of current liabilities is more than the percentage of current assets in both the companies.

(3) A close look at the balance sheets shows that investments in fixed assets have been financed from working capital in both the companies.

(4) Both the companies face capital problem and immediate steps should be taken to issue more capital and long-term loans to raise working capital.

(ii) Common Size Income Statement

The items in income statement can be shown as percentages of sales to show the relation of each item to sales. A significant relationship can be established between items of income statement and volume of sales. The increase in sales will certainly increase selling expenses In case the volume of sales increase to a considerable extent, administrative and financial expenses may go up. In case the sales are declining, the selling expenses should be reduced at once. So, a relationship is established between sales and other items in income statement and this relationship is helpful in evaluating operational activities of the enterprise.

Illustration 7. Following are the Income Statements of a company for the years ending Dec., 31, 2016 and 2017:

	2016 (Rs. is 000)	**2017 (Rs. in 000)**
Sales	500	700
Miscellaneous Income	20	15
Expenses	520	715
Cost of sales	325	510
Office expenses	20	25
Selling expenses	30	45
Interest	25	30
	400	610
Net Profit	120	105
	520	715

Solution:

COMMON-SIZE INCOME STATEMENT

For the years ending Dec. 2016 and 2017

	2016		2017	
	(000) Rs.	%	(000) Rs.	%
Sales	500	100.00	700	100.00
Less: Cost of Sales	325	65.00	510	72.86
Gross Profit	175	35.00	190	27.14
Operating Expenses:				
Office expenses	20	4.00	25	3.58

Selling expenses	30	6.00	45	6.42
Total Operating Expenses	50	10.00	70	10.00
Operating Profit	125	25.00	120	17.14
Miscellaneous Income	20	4.00	15	2.14
Total Income	145	29.00	135	19.28
Less: Non-Operating expenses				
Interest	25	5.00	30	1.25
Net Profit	120	24.00	105	15.00

Interpretation

(1) The sales and gross profit has increased in absolute figures in 2017 as compared to 2016 but the percentage of gross profit to sales has gone down in 2017.

(2) The increase in cost of sales as a percentage of sales has brought the profitability from 35 to 27.14%.

(3) Operating expenses have remained the same in both the years but non-operating expenses have decreased as a percentage in 2017. A slight decrease in non-operating expenses in the latter year could not help to improve profits.

(4) Net profits have decreased both in absolute figures and as a percentage in 2017 as compared to 2016.

(5) The overall profitability has decreased in 2017 and the reason is a rise in cost of sales. The company should take immediate steps to control its cost of sales.

5.8 LIMITATIONS OF FINANCIAL ANALYSIS

Financial analysis is a powerful mechanism of determining financial strengths and weaknesses of a firm. But, the analysis is based on the information available in the financial statements. Thus, the financial analysis suffers from serious inherent limitations of financial statements. The financial analyst has also to be careful about the impact of price level changes, window-dressing of financial statements, changes in accounting policies of a firm, accounting concepts and conventions, and personal judgment, etc. Some of the important Limitations of financial analysis are given below:

(i) It is only a study of interim reports

(ii) Financial analysis is based upon only monetary information and non-monetary factors are ignored.

(iii) It does not consider changes in price levels.

(iv) As the financial statements are prepared on the basis of going concern, it does not give exact position. Thus accounting concepts and conventions cause a serious limitation to financial analysis.

(v) Changes in accounting procedure by a firm may often make financial analysis misleading.

(vi) Analysis is only a means and not an end in itself. The analyst has to make interpretation and draw his own conclusions. Different people may interpret the same analysis in different ways.

5.9 SUMMARY

The financial statement analysis may be defined as the study of relationship between the various financial items in a business. There is some logical relationship between the different financial items for example profits are highly related with sales volume and capital employed in the business. So if we analyze the amount of profits in relation to sales or capital employed, meaningful conclusion can be drawn. The term analysis and interpretation are used inter-changeably but the distinction should be made between the two terms. The term analysis mean the simplification of financial data by classification of data and the term interpretation means explaining the meaning and significance of data so simplified. Analysis is useless without interpretation and interpretation without analysis is impossible. Some of the methods of financial of annual statements are given below:

(i) Comparative Statements

(ii) Trend Analysis

(iii) Common-size Statements.

Comparative Statements: The comparative financial statements show the financial position of a concern for different periods of time. Generally, Balance Sheet and Income Statement are prepared in comparative form. The analyst is able to draw meaning information when data is given in a comparative position. The two comparative statements are:

(i) Balance Sheet (ii) Income Statement

Trend Analysis: The information for a number of years is taken up one year, generally the first year, is taken as a base year. The figures of the base year are taken as 100 and trend ratios for other years are calculated on the basis of base year.

Common-Size Statements: The Common-size statements, balance sheet and income statement, are shown in analytical percentages. The figures are shown as percentages of total assets, total liabilities and total sales. The total assets are taken as 100 and different assets are expressed as a percentage of the total. Similarly, various liabilities are taken as a part of total liabilities. These statements are also known as component percentage or 100 percent statements because every individual item is stated as a percentage of the total 100.

5.10 KEY WORDS

Income Statement: A statement showing the results of the operations of a business.

Balance Sheet: A statement showing the financial position of a business firm.

Current Assets: Those assets which will be converted into cash within one year.

Current Liabilities: Those liabilities which will be paid within one year.

5.11 SELF ASSESSMENT QUESTIONS

Q. 1. What do you understand by the analysis and interpretation of financial statements? Discuss their utility and significance to the management and others who are interested in the business.

Q. 2. What are the different methods used for the analysis and interpretation of financial statements.

Q. 3.What is common-size balance sheet and income statement? Explain the technique of preparing the common-size balance sheet.

Q. 4. What is the importance to management of comparative statements? Illustrate your answer with particular reference to Comparative Revenue Statements and State briefly how these statements are prepared.

Q. 5. Explain the usefulness of trend percentages in interpretation of financial performance of a company.

Q. 6.“Analysis without interpretation is meaningless and interpretation without analysis is impossible.” Discuss.

Q. 7. State the different types of financial analysis and discuss the limitations of analysis and interpretation of financial statements.

Q. 8. The following are the Balance Sheets of Surindra Ltd. For the years ending 31st December 2016 and 2017.

	2016	2017		2016	2017
	Rs.	Rs.		Rs.	Rs.
Equity Share			Fixed Assets Less		
Capital	2,00,000	3,30,000	Depreciation	2,40,000	3,50,000
Preference Share			Stock	40,000	50,000
Capital	1,00,000	1,50,000	Debtors	1,00,000	1,25,000
Reserves	20,000	30,000	Bills Receivables	20,000	60,000
Profit and Loss A/c	15,000	20,000	Prepaid Expenses	10,000	12,000
Bank Overdraft	50,000	50,000	Cash in hand	40,000	53,000
Creditors	40,000	50,000	Cash at bank	10,000	30,000
Provision for					
Taxation	20,000	25,000			
Preposed Dividend	15,000	25,000			
	4,60,000	6,80,000		4,60,000	6,80,000

Prepare a comparative balance Sheet of the company and study its financial position.

Q. 9. With the help of Company Balance Sheet, study the financial position of Mahindra and Mahindra Ltd. Bombay for the years 2016 and 2017.

BALANCE SHEETS

For the years ending 31st December 2016 and 2017

(Rs. in 000)

Liabilities	2016	2017	Assets	2016	2017
6% Redeemable			Fixed Assets		
Cum-Pref. Share			Less Depreciation	9,705	11,032
Capital	2,500	2,500	Investments	1,947	2,429
6½ % Redemable			Current Assets		
Cum- Pref. Share			Receivables	1,217	1,584
Capital	–	3,000	Advance Payment		
Ordinary Share			of Tax	1,818	500
Capital	5,500	13,200	Cash and Bank Bank		
Reserves	2,500	3,450	Balances	2,419	1,886
Profit & Loss A/c	116	99	Sundry Debtors	38,700	36,951
Loans & Advances	71,745	51,282	Stock in trade	52,334	36,769
Sundry creditors	27,122	14,734	Stores, spare parts		
Provision for			and tools, etc.	1,890	2,042
Taxation	5,012	4,578	Prepaid expenses	7,957	3,772
Customers					
Credit Balances	1,603	2,079			
Accruals (Interest					
On securities)	695	237			
Unclaimed					
Dividend	6	107			
Provisions for					
Proposed dividend	1,113	1,420			
Provision for con-tingent					
Liability	75	81			
Provision for gratuity	–	198			

	1,17,987	96,965		1,17,987	96,965

5.12 SUGGESTED READINGS

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