



BUDDHA SERIES

(Unit Wise Solved Question & Answers)

Course – BBA 1st Sem

College – Buddha Institute of Management

(DDU Code-1212)

Department: Business Administration

Subject: Management Accounting

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Unit-1

Question-1. Define management accounting.

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

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

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

The Institute of Chartered Accountants of India defines Management Accounting as, "Such of its techniques and procedures by which accounting mainly seeks to aid the management collectively has come to be known as management accounting"

From these definitions, it is very clear that financial data is recorded, analyzed and presented to the management in such a way that it becomes useful and helpful in planning and running business operations more systematically.

Question-2: Explain the objectives of management accounting.

Answer: OBJECTIVES OF MANAGEMENT ACCOUNTING

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

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

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

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

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

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

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

Question:3- Discuss the advantages and limitations of management accounting.

Answer: ADVANTAGES OF MANAGEMENT ACCOUNTING

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

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

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

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

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

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

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

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

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

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

LIMITATIONS OF MANAGEMENT ACCOUNTING

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

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

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

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

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

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

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

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

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

Question:4 Explain the functions and scope of management accounting.

Answer: Functions of Management Accounting

The basic function of management accounting is to assist the management in performing its functions effectively. The functions of the management are planning, organizing, directing and controlling. Management accounting helps in the performance of each of these functions in the following ways:

(i) Provides Data: Management accounting serves as a vital source of data for management planning. The accounts and documents are a repository of a vast quantity of data about the past progress of the enterprise, which are a must for making forecasts for the future.

(ii) Modifies Data: The accounting data required for managerial decisions is properly compiled and classified. For example, purchase figures for different months may be classified to know total purchases made during each period product-wise, supplier-wise and territory-wise.

(iii) Analyses and Interprets Data: The accounting data is analyzed meaningfully for effective planning and decision-making. For this purpose the data is presented in a comparative form. Ratios are calculated and likely trends are projected.

(iv) Serves as a means of Communicating: Management accounting provides a means of communicating management plans upward, downward and outward through the organization. Initially, it means identifying the feasibility and consistency of the various segments of the plan. At later stages it keeps all parties informed about the plans that have been agreed upon and their roles in these plans.

(v) Facilitates Control: Management accounting helps in translating given objectives and strategy into specified goals for attainment by specified time and secures effective accomplishment of these goals in an efficient manner. All this is made possible through budgetary control and standard costing which is an integral part of management accounting.

(vi) Uses also Qualitative Information: Management accounting does not restrict itself to financial data for helping the management indecision making but also uses such information which may not be capable of being measured in monetary terms. Such information may be collected from special surveys, statistical compilations, engineering records, etc.

Scope of Management Accounting

1. Financial Accounting: Financial Accounting deals with the historical data. The recorded facts about an organization are useful for planning the future course of action. Though planning is always for the future but still it has to be based on past and present data. The control aspect too is based on financial data. The performance appraisal is based on recorded facts and figures. So management accounting is closely related to financial accounting.

2. Cost Accounting: Cost Accounting provides various techniques for determining cost of manufacturing products or cost of providing service. It uses financial data for finding out cost of various jobs, products or processes. The systems of standard costing, marginal costing, differential costing and opportunity costing are all helpful to the management for planning various business activities.

3. Financial Management: Financial Management is concerned with the planning and controlling of the financial resources of the firm. It deals with rising of funds and their effective utilization so to maximise earnings. Finance has become so important for every business that all managerial activities are connected with it. Financial viability of various propositions influences decisions on them. Therefore management accounting includes and extends to the operation of financial management also.

4. Budgeting and Forecasting: Budgeting means expressing the plans, policies and goals of the enterprise for a definite period in future. The targets are set for different departments and responsibility is fixed for achieving these targets. The comparison of actual performance with budgeted figures will give an idea to the management about the performance of different departments. Forecasting, on the other hand, is a prediction of what will happen as a result of a given set of circumstances. Both budgeting and forecasting are useful for management accountant in planning various activities.

5. Inventory Control: Inventory is used to denote stock of raw materials, goods in the process of manufacture and finished products. Inventory has a special significance in accounting for determining correct income for a given period. Inventory control is significant as it involves large sums. The management should determine different levels of stocks, i.e. minimum level, maximum level, re-ordering level for inventory control. The control of inventory will help in controlling costs of products. Management accountant will guide management as to when and from where to purchase and how much to purchase. So the study of inventory control will be helpful for taking managerial decisions.

6. Reporting to Management: One of the functions of management accountant is to keep the management informed of various activities of the concern so as to assist it in controlling the enterprise. The reports are presented in the form of graphs, diagrams, index numbers or other statistical techniques so as to make them easily understandable. The management accountant sends interim reports to the management and these reports may be monthly, quarterly, half – yearly. The reports may cover profit and loss statement, cash and found flow statements, stock reports, absentee reports and reports on orders in hand, etc. These reports are helpful in giving a constant review of working of the business.

7. Interpretation of Data: The management accountant interprets various financial statements to the management. These statements give an idea about the financial and earning position of the concern. These statements may be studied in comparison to statements of earlier periods or in comparison with the statements of similar other concerns. The significance of these reports is explained to the management in a simple language. If the statements are not properly interpreted then wrong conclusions may be drawn. So interpretation is also important as compiling of financial statements.

8. Control procedures and Method: Control procedures and methods are needed to use various factors of production in a most economical way. The studies about cost, relationship of cost and profits are useful for using economic resources efficiently and economically.

9. Internal Audit: Internal audit system is necessary to judge the performance of every department. The actual performance of every department and individual is compared with the pre-determined standards. Management is able to know deviations in performance. Internal audit helps management in fixing responsibility of different individuals.

10. Tax Accounting: In the present complex tax systems, tax planning is an important part of management accounting. Income statements are prepared and tax liabilities are calculated. The management is informed about the tax burden from central government, state government and local authorities. Various tax returns are to be filed with different departments and tax payments are to be made in time. Tax accounting comes under the purview of management accountant's duties.

Question:5- Explain the role and responsibilities of management accountant.

Answer: Roles of Management Accountant

Management Accountant, otherwise called Controller, is considered to be a part of the management team since he has the responsibility for collecting vital information, both from within and outside the company. The functions of management accountant are:

- To establish, coordinate and administer, as an integral part of management, an adequate plan for the control of operations. Such a plan would provide, to the extent required in the business cost standards, expense budgets, sales forecasts, profit planning, and programme for capital investment and financing, together with necessary procedures to effectuate the plan.

- To compare performance with operating plan and standards and to report and interpret the results of operation to all levels of management, and to the owners of the business. This function includes the formulation and administration of accounting policy and the compilations of statistical records and special reports as required.
- To consult with segments of management responsible for policy or action concerning any phase of the operations of business as it relates to the attainment of objective, and the effectiveness of policies, organization structures, procedures.
- To administer tax policies and procedures.
- To supervise and coordinate preparation of reports to Government agencies.
- To assure fiscal protection for the assets of the business through adequate internal; control and proper insurance coverage.
- To continuously appraise economic and social forces and government influences, and interpret their effect upon business.

Duties and Responsibilities of Management Accountant

The primary duty of Management Accountant is to help management in taking correct policy-decisions and improving the efficiency of operations. He performs a staff function and also has line authority over the accountants. If management accountant feels that a decision likely to be taken by the management based on the information tendered by him shall be detrimental to the interest of the concern, he should point out this fact to the concerned management, of course, with tact, patience, firmness and politeness. On the other hand, if the decision taken happens to be wrong one on account of inaccuracy, biased and fabricated data furnished by the management accountant, he shall be held responsible for wrong decision taken by the management. Following are the duties of Management Accountant or controller:

- The installation and interpretation of all accounting records of the corporation.
- The preparation and interpretation of the financial statements and reports of the corporation.
- Continuous audit of all accounts and records of the corporation wherever located.
- The compilation of costs of distribution.
- The compilation of production costs.
- The taking and costing of all physical inventories.
- The preparation and filing of tax returns and to the supervision of all matters relating to taxes.
- The preparation and interpretation of all statistical records and reports of the corporation.
- The preparation as budget director, in conjunction with other officers and department heads, of an annual budget covering all activities of the corporation of submission to the Board of Directors prior to the beginning of the fiscal year. The authority of the Controller, with respect to the veto of commitments of expenditures not authorized by the budget shall, from time to time, be fixed by the board of Directors.
- The ascertainment currently that the properties of the corporation are properly and adequately insured.
- The initiation, preparation and issuance of standard practices relating to all accounting, matters and procedures and the co-ordination of system throughout the corporation including clerical and office methods, records, reports and procedures.
- The maintenance of adequate records of authorized appropriations and the determination that all sums expended pursuant there into are properly accounted for.

- The ascertainment currently that financial transactions covered by minutes of the Board of Directors and/ or the Executive committee are properly executed and recorded.
- The maintenance of adequate records of all contracts and leases.
- The approval for payment(and / or countersigning) of all cheques, promissory notes and other negotiable instruments of the corporation which have been signed by the treasurer or such other officers as shall have been authorized by the by-laws of the corporation or from time to time designated by the Board of Directors.
- The examination of all warrants for the withdrawal of securities from the vaults of the corporation and the determination that such withdrawals are made in conformity with the by-laws and /or regulations established from time by the Board of Directors.
- The preparation or approval of the regulations or standard practices, required to assure compliance with orders of regulations issued by duly constituted governmental agencies.

Question:6- Differentiate between Financial Accounting and Management Accounting.

Answer: Difference between Financial Accounting and Management Accounting

BASIS	FINANCIAL ACCOUNTING	MANAGEMENT ACCOUNTING
Meaning	Financial Accounting is an accounting system that focuses on the preparation of a financial statement of an organization to provide financial information to the interested parties.	The accounting system which provides relevant information to the managers to make policies, plans and strategies for running the business effectively is known as Management Accounting.
Orientation	Historical	Future
Users	Both internal and external users	Only internal users
Nature of statements prepared	General-purpose financial statements	Special purpose financial statements
Rules	Rules of GAAP are followed	No fixed rules for the preparation of reports
Reports	Only financial aspects	Both financial and non-financial aspects
Time Span	Financial statements are prepared for a fixed period, i.e. one year.	Management Reports are prepared whenever needed.
Objective	To create periodical reports	To assist internal management in planning and decision-making process by providing detailed information on various matters.

BASIS	FINANCIAL ACCOUNTING	MANAGEMENT ACCOUNTING
Publishing and auditing	Required to be published and audited by statutory auditors	It is not meant to be published or audited. It is for internal use only.
Format	Specified	Not Specified

Question:7- Describe the costs classified on the basis of time and elements.

Classification of Costs

Cost can be divided into various basis- Time (Historical, Predetermined), Basis of Elements (Material, Labor and Overheads), Basis of function (Production, Marketing, Selling), Basis of Traceability (Direct and Indirect Cost), Basis of Activity (Fixed, Variable), Basis of Normality (Normal and Abnormal), and Basis of Analytics (Opportunity, Joint).

On the Basis of Time

Cost classification based on time helps businesses understand expenses over different periods for better financial planning. It is divided into various types of costs, such as historical, predetermined, estimated and standard cost.

Historical Cost

Historical cost refers to the original cost of an asset or liability when acquired or incurred. Companies often use historical costs in accounting to value assets and liabilities on a company's balance sheet. This means we record assets or liabilities at their original cost rather than their current market value or replacement cost.

Predetermined Cost

A predetermined cost is a budgeted or estimated cost established before producing or purchasing goods or services. Companies typically use it in cost accounting and managerial accounting to help them plan and control costs.

Estimated Cost

Estimated cost refers to calculating or projecting the expected cost of a project, product, or service. We can typically use it in project management, construction, manufacturing, and other industries where cost estimation is an important part of planning and budgeting.

Standard Cost

Standard cost refers to a predetermined cost established as a benchmark for measuring actual costs in a manufacturing or production process. It is used in cost accounting to help companies plan and control costs and to identify areas where cost savings can be achieved.

On the Basis of Nature or Elements

Cost of Material

Cost of materials refers to the raw materials and components used to produce a product or service. This includes the cost of any materials that companies purchase from suppliers, as well as the cost of any materials that they produce or process in-house.

Cost of Labour

Labour costs refer to wages, salaries, benefits, and other expenses associated with the labour required to produce a product or service. This includes the cost of all employees involved in the production process, such as direct labourers, supervisors, and support staff.

Expenses

Expenses refer to the costs incurred by a business or individual to generate revenue or achieve a particular objective. They are typically classified into two main categories: operating and non-operating expenses.

Question:8- Discuss the costs classified on the basis of function and behaviour.

On the Basis of Function

Cost of Production

The cost of production refers to the total expense incurred by a business in creating and selling its products or services. These expenses may include costs associated with raw materials, labour, equipment, rent, utilities, marketing, and other overhead expenses.

Cost of Marketing

The marketing cost refers to the expenses incurred by a business or organization to promote its products, services, or brand to potential customers or clients. These costs can include advertising fees, promotional materials, public relations expenses, and salaries or fees for marketing personnel.

Cost of Selling

The cost of selling refers to the expenses incurred by a business or organization to sell its products or services to customers. These costs can include salaries or commissions for sales personnel, advertising and marketing expenses, travel and entertainment costs associated with sales efforts, and any fees associated with payment processing or shipping.

On the Basis of Traceability

Direct Cost

Direct costs are expenses companies can directly attribute to producing a specific product or service. These costs are typically associated with the materials, labour, and equipment needed to create the product or service. Direct costs include:

Raw materials.

Wages for manufacturing personnel.

The cost of equipment and machinery used in the production process.

Indirect Cost

Indirect costs are expenses not directly related to the production of a specific product or service but are necessary for the business to operate. We typically associate these costs with overhead and administrative expenses such as rent, utilities, and office supplies. Indirect costs can also include salaries for non-production personnel such as management, marketing, and accounting staff.

On the Basis of Activity or Volume or Behaviour

Fixed Cost

Fixed costs remain constant regardless of the activity level or volume. These costs only change slowly, even if production increases or decreases. Examples of fixed costs include rent, property taxes, and salaries for non-production personnel.

Variable Cost

Variable Costs: Variable costs are expenses that fluctuate based on the activity level or volume. These costs increase or decrease as production levels change. Examples of variable costs include raw materials, direct labour, and sales commissions.

Sem-Variable Cost

Semi-variable costs, also known as semi-fixed costs, are expenses that have both fixed and variable components. These costs may have a fixed portion that remains constant regardless of activity or volume and a variable portion that fluctuates based on production levels. Semi-variable costs include utilities, maintenance, and some types of labour.

Question:9- Describe the costs classified on the basis of normality and decision making.

On the Basis of Normality

Normal Cost

Normal costs are expenses typically incurred during the normal course of business operations. These costs are considered predictable and expected and are included in the cost of goods sold or operating expenses. Examples of normal costs include raw materials, direct labour, and utilities.

Abnormal Cost

Abnormal costs, also known as extraordinary costs, are not considered part of normal business operations. These costs are unexpected and typically result from unforeseen events or circumstances. Examples of abnormal costs include repairs due to natural disasters, legal settlements, and expenses related to a sudden drop in demand for a product or service.

On the basis of Analytical and Decision Making Purpose

Opportunity Cost

Opportunity cost refers to the value of the best alternative forgone when deciding. In other words, it's the cost of the missed opportunity. Whenever a decision is made, there are always choices that are not pursued. The opportunity cost is the value of the benefits that would have been gained from the next best alternative that was not chosen.

For example, a person has Rs. 10,000 to spend and is trying to decide whether to buy a new jacket or go to dinner. If they choose to buy the coat, the opportunity cost is the dinner value they didn't go to. If they decide to go out to dinner, the opportunity cost is the value of the jacket that they didn't buy.

Joint Cost

Joint cost is a type of cost that arises when a single production process generates multiple products or outputs simultaneously. These products cannot be easily separated or identified as individual products until a certain point in production. Joint costs are incurred up to that point and allocated to the different products based on some agreed-upon cost allocation method.

An example of joint cost can be seen in oil and gas production. When oil is extracted from a well, it often comes out along with natural gas. Extracting oil and gas incurs joint costs, such as drilling the well and operating the extraction equipment. These joint costs must be allocated to the different products to determine their costs and profitability.

Sunk Cost

Sunk cost refers to a cost that has already been incurred and cannot be recovered or changed, regardless of any future actions taken. In other words, it's a cost that has been spent and cannot be reversed.

An example of a sunk cost would be a non-refundable airline ticket. Once the ticket has been purchased, the cost is sunk and cannot be recovered, even if the traveller decides not to use the ticket.

Differential Cost

Differential cost, also known as incremental cost, refers to the difference in cost between two alternatives. In other words, it's the additional cost incurred or saved by choosing one option over another.

Differential cost can be calculated by subtracting one option's cost from another's. For example, if a business decides whether to produce a product in-house or outsource production to a third-party manufacturer, the differential cost would be the difference in cost between producing the product in-house and outsourcing production.

Common Cost

Common cost is incurred for the joint benefit of two or more products, departments, or activities within an organization. These costs are not directly traceable to a specific product or activity and cannot be easily allocated to a single cost object.

An example of a common cost would be the rent for a building shared by multiple organizational departments. The cost of rent is incurred for the joint benefit of all departments and cannot be easily allocated to a single department based on usage.

Imputed Cost

Imputed cost refers to a cost that is not incurred but is assigned to a particular activity or product to reflect its true economic cost. These costs are often used in cost accounting to provide a more accurate picture of the true costs of an activity or product.

An example of the imputed cost would be using a company-owned building or equipment for a particular activity or project. While the company may not incur any actual expenses for using the building or equipment, an imputed cost would be assigned to the activity or project to reflect the true economic cost of using those resources.

Capacity Cost

Capacity cost refers to the fixed costs associated with an organization's production capacity, regardless of the production level. These costs include rent, property taxes, building, machinery, and equipment insurance.

Capacity costs are incurred regardless of whether the organization is operating at full capacity or producing at a lower level. They are typically considered sunk costs in the short run. However, businesses can adjust their production capacity to reduce or optimize capacity costs in the long run.

Marginal Cost

Marginal cost is an important concept in economics and business, as it helps firms determine the most efficient production level. Businesses can determine whether producing additional output units is profitable by comparing the marginal cost to marginal revenue. Suppose the marginal revenue generated by producing an additional unit exceeds the marginal cost. In that case, the firm should continue to produce more units until marginal revenue equals marginal cost.

Replacement Cost

Replacement cost replaces an asset or item with a new or similar item of equal value. It is the cost that would be incurred to replace an asset at its current market value rather than the historical or original cost of the asset.

For example, if a business's computer equipment is destroyed in a fire, the replacement cost would be the amount of money needed to purchase new equipment of the same or similar specifications rather than the cost of the original equipment when it was purchased.

Out-of-Pocket Cost

Out-of-pocket cost refers to the expenses that an individual or business incurs for goods or services not covered by insurance or other reimbursement forms. These costs are paid directly by the individual or business and are not reimbursed by a third party.

Examples of out-of-pocket costs may include deductibles, copayments, coinsurance, and expenses for services not covered by insurance, such as elective medical procedures. Out-of-pocket costs may include travel, lodging, and other incidental expenses associated with medical care or other services.

Question:10- Differentiate absorption costing and marginal costing.

Absorption costing and marginal costing

Absorption costing and marginal costing are two different methods of assigning costs to products, with key differences in how they handle fixed and variable costs. Absorption costing includes both variable and fixed production costs as part of the product's cost, while marginal costing only includes variable costs.

Key Differences Summarized:

Feature	Absorption Costing	Marginal Costing
Fixed Costs	Included in product costs	Treated as period costs
Inventory	Higher (includes fixed	Lower (only variable costs)

Value	overheads)	
Profitability	Can be affected by production levels	More accurately reflects contribution
Primary Use	Financial Reporting, External Reporting	Management Decision Making, Short-term Planning

Unit-2

Question:1- what is marginal cost?

Answer: Marginal Cost

Meaning

Marginal Cost is nothing but Variable Cost, comprising prime cost and variable overheads. Cost which varies in direct proportion to any change in the volume of output is known as Marginal Cost.

Definition

MC indicates the rate at which the total cost of a product changes as the production increases by one unit. However, because fixed costs do not change based on the number of products produced, the marginal cost is influenced only by the variations in the variable costs.

Marginal Cost is particularly important in the business decision-making process. Management has to make decisions on where to best allocate resources in the production process. For instance, when the management needs to decide whether to increase production or not, they have to compare the marginal cost with the marginal revenue that will be realized by an additional unit of output.

Question:2- what is marginal costing? Explain the assumptions and features of marginal costing.

Answer: Marginal Costing

Meaning

Marginal Costing is a technique where by only the variable costs are considered while computing the cost of the product. The fixed costs are written off against profits in the period in which they arise.

Marginal Costing is not a system of costing such as process costing, job costing, operating costing, etc. but a technique which is concerned with the changes in costs and profits resulting from changes in the volume of output. Marginal costing is also known as ‘variable costing’

Definitions

The Chartered Institute of Management Accountant (CIMA), London, defined marginal costing as —the amount at any given volume of output by which aggregate costs are changed, if the volume of output is increased or decreased by one unitl.

The Institute of Cost and Management Accountants, London, has defined Marginal Costing as —the ascertainment of marginal costs and of the effect on profit of changes in volume or type of output by differentiating between fixed costs and variable costs.

According to Batty, —Marginal costing is a technique of cost accounting which pays special attention to the behavior of cost with changes in the volume of output.

Assumptions of Marginal Costing

The technique of Marginal Costing is based upon the following assumptions:

1. All elements of cost—production, administration and selling and distribution—can be segregated into fixed and variable components.
2. Variable cost remains constant per unit of output irrespective of the level of output and thus fluctuates directly in proportion to changes in the volume of output.
3. The selling price per unit remains unchanged or constant at all levels of activity.
4. Fixed costs remain unchanged or constant for the entire volume of production.
5. The volume of production or output is the only factor which influences the costs.

Features of Marginal Costing

The following are the main features of Marginal Costing:

1. This technique is used to ascertain the marginal cost and to know the impact of variable costs on the volume of output.

2. All costs are classified on the basis of variability into fixed cost and variable cost. Semivariable costs are segregated into fixed and variable costs.
3. Marginal (i.e., variable) costs are treated as the cost of the product or service. Fixed costs are charged to Costing Profit and Loss Account of the period in which they are incurred.
4. Stock of finished goods and work-in-progress are valued on the basis of marginal costs.
5. Selling price is based on marginal cost plus contribution.
6. Profit is calculated in the usual manner. When marginal cost is deducted from sales it gives rise to contribution. When fixed cost is deducted from contribution it results in profit.
7. Break-even analysis and cost-volume profit analysis are integral parts of this technique.
8. The relative profitability of products or departments is based on the contribution made available by each department or product.

Question:3- Discuss the characteristics of marginal costing.

Answer: Characteristics of Marginal Costing

The main characteristics of marginal costing are as follows:

1. It is a technique of analysis and presentation of costs which help management in taking many managerial decisions and is not an independent system of costing such as process costing or job costing.
2. All elements of cost—production, administration and selling and distribution are classified into variable and fixed components. Even semi-variable costs are analysed into fixed and variable.
3. The variable costs (marginal costs) are regarded as the costs of the products.
4. Fixed costs are treated as period costs and are charged to profit and loss account for the period for which they are incurred.
5. The stocks of finished goods and work-in-process are valued at marginal costs only.
6. Prices are determined on the basis of marginal cost by adding ‘contribution’ which is the excess of sales or selling price over marginal cost of sales.

Question:4- Explain the advantages and limitations of marginal costing.

Answer: Advantages of Marginal Costing

The following are the important advantages of marginal costing:

1. The technique of marginal costing is very simple to operate and easy to understand. Since, fixed costs are kept outside the unit cost; the cost statements prepared on the basis of marginal cost are much less complicated.
2. It does away with the need for allocation, apportionment and absorption of fixed overheads and hence removes the complexities of under-absorption of overheads.
3. Marginal cost remains the same per unit of output irrespective of the level of activity. It is constant in nature and helps the management in production planning.

4. It prevents the carry forward of current year's fixed overheads through valuation of closing stocks. Since fixed costs are not considered in valuation of closing stocks, there is no possibility of factitious profits by over-valuing stocks.
5. It facilitates the calculation of various important factors, viz., break-even point, expectations of profits at different levels of production, sales necessary to earn a predetermined target of profit, effect on profit due to changes of raw materials prices, increased wages, change in sales mixture, etc.
6. It is a valuable aid to management for decision-making and fixation of selling prices, selection of a profitable product/sales mix, make or buy decision, problem of key or limiting factor, determination of the optimum level of activity, close or shut down decisions, evaluation of performance and capital investment decisions, etc.
7. It facilitates the study of relative profitability of different product lines, departments, production facilities, sales divisions, etc.
8. It is complimentary to standard costing and budgetary control and can be used along with them to yield better results.
9. Since fixed costs are not controllable and it is only variable or marginal cost that is controllable, marginal costing, by dividing costs into controllable and non-controllable, help in cost control.
10. It helps the management in profit planning by making a study of relationship between cost, volume and profits. Further, break-even charts and profit graphs make the whole problem easily understandable even to a layman.
11. It is very useful in management reporting, marginal costing facilitates 'management by exception' by focusing attention of the management towards more important areas than to waste time on problems which do not require urgent attention of the higher managements.

Limitations of Marginal Costing:

In spite of so many advantages, the technique of marginal costing suffers from the following limitations:

1. The technique of marginal costing is based upon a number of assumptions which may not hold well under all circumstances.
2. All costs are not divisible into fixed and variable. There are certain costs which are semi-variable in nature; it is very difficult and arbitrary to classify these costs into fixed and variable elements.
3. Variable costs do not always remain constant and do not always vary in direct proportion to volume of output because of the laws of diminishing and increasing returns.
4. Selling prices do not remain constant forever and for all levels of output due to competition, discounts for bulk orders, changes in the general price level, etc.
5. Fixed costs do not remain constant after a certain level of activity. Further, marginal costing ignores the fact that fixed costs are also controllable.
6. The exclusion of fixed costs from the stocks of finished goods and work-in-progress is illogical since fixed costs are also incurred on the manufacture of products. Stocks valued on marginal costing are

undervalued and the profit and loss account cannot reveal true profits. Similarly, as the stock is undervalued, the balance sheet does not give a true picture.

7. Although the technique of marginal costing overcomes the problem of under or over absorption of fixed overheads, the problem still exists in regard to under or over-absorption of variable overheads.

8. Marginal costing completely ignores the 'time factor'. Thus, if two jobs give equal contribution but one takes longer time to complete, the one which takes longer time should be regarded as costlier than the other. But this fact is ignored altogether under marginal costing.

9. The technique of marginal costing cannot be applied in contract or ship-building industry because in such cases, normally the value of work-in-progress is very high and the exclusion of fixed overheads may result into losses every year and huge profit in the year of completion of the job.

10. Cost control can be better be achieved with the help of other techniques, viz., standard costing and budgetary control than by marginal costing technique.

11. Fixation of selling prices in the long run cannot be done without considering fixed costs. Thus, pricing decisions cannot be based on marginal cost alone.

12. In the present days of automation, the proportion of fixed costs in relation to variable costs is very high and hence managerial decisions based upon only the marginal cost ignoring equally important element of fixed cost may not be correct.

Question:5- Explain the applications of marginal costing for decision making.

Answer: Application of Marginal Costing

The following points highlight the techniques of application of marginal costing.

1. Profit Planning

Profit planning is the planning of future operations to attain maximum profit. Under the technique of marginal costing, the contribution ratio, i.e., the ratio of marginal contribution to sales, indicates the relative profitability of the different products of the business whenever there is any change in volume of sales, marginal cost per unit, total fixed costs, selling price, and sales-mix etc. Hence marginal costing is a useful tool in planning profits as it ensures sufficient return on capital employed.

2. Pricing of Products

Sometimes pricing decisions have to be taken to cater to a recessionary market or to utilize spare capacity where only marginal cost is recovered. For export market, sometimes full cost is loaded to the sale price to remain competitive. Sometimes special prices are to be offered with expansion in mind, fixation of price below cost can be made on a short-term basis.

It may be advisable to fix prices equal to or below marginal cost under the following cases:

- i. To maintain production and employees occupied.
- ii. To keep plant in use in readiness to go 'full team ahead'.
- iii. To prevent loss of future orders.
- iv. To dispose of perishable product.

- v. To eliminate competition of nearer rivals.
- vi. To popularize a new product.
- vii. To keep the sales of a joined product which make a considerable amount of profit.
- viii. Where prices have fallen considerably or a loss has already been made.

3. Introduction of a Product

When a new product is introduced without incurring any additional fixed cost the additional contribution helps to increase profitability.

4. Selection of Product Mix

The most-profitable product mix can be determined by applying marginal costing technique. Fixed cost remaining constant, the most profitable product-mix is determined on the basis of contribution only. That product-mix which gives maximum contribution is to be considered as best products mix.

5. Problem of Key/Limiting Factor

A key factor is a factor which limits the volume of production and profit of business. It may be scarcity of any factor of production such as material labour, capital, plant capacity etc. Usually, when there is no key or limiting factor, the product is selected on the basis of highest P/V ratio of the product. But with key factor the selection of product will be on the basis of contribution per unit of limiting/key factor of production.

6. Alternative Method of Manufacture

When alternative use of production facilities or alternative methods of manufacturing a product are being considered, the alternative which gives the maximum marginal contribution is selected.

7. Make-or-Buy Decision

A company may have idle capacity which may be utilised for making a component or a product, instead of buying them from outside sources. In taking such ‘_make-or-buy’ decision, a comparison should be made between the variable (or marginal) cost of manufacture of the product and the supplier’s price for it.

It will be advantageous to manufacture than to purchase an item if the variable cost is lower than the purchase price provided that the decision to manufacture does not result in substantial increase in fixed costs and that the existing manufacturing facilities cannot be otherwise utilized more profitably.

8. Accepting Additional Orders and Exploring Foreign Market

Sometimes goods are sold at a price above total cost (i.e., at a profit) and still there remains some spare or unused capacity. In such circumstances, extra order may be accepted or goods may be sold in a foreign market at a price above marginal cost but below total cost.

This will add to the profits as, after full recovery of the fixed cost, any contribution—either from additional orders or from selling in the foreign market—will make extra profit. In this way the spare plant capacity can be used to earn additional profit.

9. Increasing or Decreasing Departments or Products

Sometimes general fixed costs are apportioned to departments or products for ascertaining total cost but it may give misleading results. However, specific fixed costs traceable to departments or products should be

deducted from individual contribution to get the Net contribution. If the net contribution of a department or product is positive, then it should not be discarded.

10. Closing Down/Suspending Activities

While taking a decision in this line, the effect of fixed cost and contribution will have to be analysed. If the contribution is more than the difference in fixed costs by working at normal operations, and when the plant or product is closed down or suspended, then it is desirable to continue operation.

Question:6- What is CVP Analysis?

Answer: COST VOLUME PROFIT ANALYSIS

Cost Volume Profit Analysis (CVP) is a systematic method of examining the relationship between changes in the volume of output and changes in total sales revenue, expenses (costs) and net profit. It is the analysis of the relationship existing amongst costs, sales revenues, output and the resultant profit.

Question: 7- Describe the objectives of CVP Analysis. What is marginal cost equation?

Answer: Objectives of Cost Volume Profit Analysis

The following are the important objectives of cost volume profit analysis:

1. Cost volume is a powerful tool for decision making.
2. It makes use of the principles of Marginal Costing.
3. It enables the management to establish what will happen to the financial results if a specified level of activity or volume fluctuates.
4. It helps in the determination of break-even point and the level of output required to earn a desired profit.
5. The PV ratio serves as a measure of efficiency of each product, factory, sales area etc. and thus helps the management to choose a most profitable line of business.
6. It helps us to forecast the level of sales required to maintain a given amount of profit at different levels of prices.

Marginal Cost Equation

The following are the main important equations of Marginal Cost:

$\text{Sales} = \text{Variable Cost} + \text{Fixed Expenses} \pm \text{Profit I Loss}$

(or)

$\text{Sales} - \text{Variable Cost} = \text{Fixed} + \text{profit} (-\text{loss})$

$\text{Sales} - \text{Variable Cost} = \text{Contribution}$

$\text{Contribution} = \text{Fixed Cost} + \text{Profit}$

Question:8- Explain contribution, P/V ratio, and MOS in brief.

Answer: Contribution

The term Contribution refers to the difference between Sales and Marginal Cost of Sales. It also termed as "Gross Margin." Contribution enables to meet fixed costs and profit. Thus, contribution will first covered fixed cost and then the balance amount is added to Net profit.

Contribution can be represented as:

$$\text{Contribution} = \text{Sales} - \text{Marginal Cost } C=S-M.C$$

$$\text{Contribution} = \text{Sales} - \text{Variable Cost } C=S-V.C$$

$$\text{Contribution} = \text{Fixed Expenses} + \text{Profit } C=F.C+P$$

$$\text{Contribution} - \text{Fixed Expenses} = \text{Profit } C-F.C=P$$

$$\text{Sales} - \text{Variable Cost} = \text{Fixed Cost} + \text{Profit } S-V.C=F.C+P$$

Where:

C = Contribution

S = Sales

F :: Fixed Cost

P = Profit

V = Variable Cost

Profit Volume Ratio (P / V Ratio)

Profit Volume Ratio is also called as Contribution Sales Ratio (or) Marginal Income Ratio (or) Variable Profit Ratio. It is used to measure the relationship of contribution, the relative profitability of different products, processes or departments.

The following formula for calculating the P I V Ratio is given below:

$$P/V \text{ Ratio} = \text{Contribution} \times 100 / \text{Sales}$$

$$P/V \text{ Ratio} = \text{Change in Profit} \times 100 / \text{Change in Sales}$$

Margin of Safety:

The term Margin of Safety refers to the excess of actual sales over the break-even sales. It is known as the Margin of Safety. Margin of safety can also be expressed as a percentage of sales. Margin of safety can be improved by:

1. Increasing the selling price
2. Reducing the variable cost
3. Selecting a product mix of larger PN ratio items
4. Reducing fixed costs
5. Increasing the output

Question:9- Describe Break- Even –Analysis in details.

Answer: Break-Even Analysis

Break-Even Analysis is a widely used technique to study Cost-Volume-Profit relationship. In a narrow sense, Break-Even Analysis concerned with the break-even point and in a broad sense, it refers to a system of analysis which is used to determine the profit at any level of production. Break-Even Analysis is a logical extension of marginal costing. It establishes the relationship of cost, volume and profit, so it is also designated as Cost-Volume Profit Analysis. CVP analysis includes the entire gamut profit planning, while break-even analysis is one of the techniques used in this process.

In order to understand the concept of Break-Even Analysis, the following terms are studied:

a. Break Even Point:

It is a point at which the total costs are exactly equal to total revenue. In this point there is no profit or no loss. At this point, the income of the business equals its expenditure. If sales go up beyond this point, the firm makes profit. If they come down, the loss is incurred. The formula is

$$\text{B.E.P. (in units)} = \text{Fixed Cost} / \text{Contribution per unit}$$

$$\text{B.E.P. (in rupees)} = \text{Fixed Cost} / \text{P/V Ratio}$$

At break-even point the profit is zero. In case the volume of sales to be computed for desired / estimated profit. The formula is:

$$\text{Sales units for desired profit} = \text{Fixed Cost} + \text{Desired Profit} / \text{Contribution per unit}$$

$$\text{Sales value for desired profit} = \text{Fixed Cost} + \text{Desired Profit} / \text{P/V Ratio}$$

b. Margin of Safety:

The difference between the actual sales at break-even point is known as the margin of safety. In other words, sales over and above break-even sales are known as margin of safety. It indicates the soundness of the business. If the margin is large, it is a sign of soundness of the business and vice versa. Margin of safety can be improved by:

- i. Increase the sales / selling price without affecting the demand
- ii. Decrease the fixed and variable cost
- iii. Change the product mix which gives more P/V ratio
- iv. Unprofitable products may be substituted by profitable ones.

c. Angle of Incidence:

The angle is formed by intersecting the sales line and the total cost line at break-even point. It indicates the profit earning capacity of the firm. Large angle indicates a high rate of profit and vice versa. A wider angle of incidence and high margin of safety indicates most favourable situations.

Question: 10- What is break even chart? Explain the relationship between Angle of Incidence, Break-Even Sales and Margin of Safety Sales.

Break Even Chart

It is the graphical representation of break-even point which shown the varying costs along with varying sales revenues. It indicates the break-even point and the estimated profit or loss at different levels of production.

According to Dr.Vance, —it is a graph showing the amounts of fixed variable costs and the sales revenue at different volumes of operation. It shown at what volume the firm first covers all costs with revenue of break-even.

According to CIMA, — a chart which shown profit or loss at various levels of activities, the level at which neither profit nor loss is shown being termed the break-even pointll.

Relationship between Angle of Incidence, Break-Even Sales and Margin of Safety Sales

- 1) When the Break-even sales are very low, with large angle of incidence, it indicates that the firm is enjoying business stability and in that case margin of safety sales will also be high.
- 2) When the break-even sales are low, but not very low with moderate angle of incidence, in that case though the business is stable, the profit earning rate is not very high as in the earlier case.
- 3) Contrary to the above when the break-even sales are high, the angle of incidence will be narrow with much lower margin of safety sales.



BUDDHA SERIES

(Unit Wise Solved Question & Answers)

Course – BBA 2nd Sem

College – Buddha Institute of Management

(AKTU Code-1212)

Department: Business Administration

Subject: Management Accounting

Faculty Name: Dr. Rama Raman Pandey

Unit – 3

Q. 1. What do you mean by Budgeting?

Ans. Budgeting: It is a managerial process. Its prime objective is to facilitate planning, co-ordination and control. Preparation of Budget, establishment of co-ordination amongst various activities of organization and to anticipate the problems, which may arise in future and efforts to solve those problems etc. are included in Budgeting.

1. "Budgeting is the preparation of comprehensive operating and financial plans for specific interval of time." -Shilling Law

2. "Budgeting is a kind of future tense accounting in which the problems of future are met on paper before the transactions actually occur." - **W.J. Barry**

It is clear from the above mentioned definitions that the method of preparing plan for future financial requirements, in present is known as budgeting. Thus, budgeting refers to planning and preparation of budget, budgetary control and other related methods.

Q. 2. Explain the purpose of budgeting.

Ans. **Purpose of Budgeting**

The major purpose of budget or budgeting are:

1. Statement of Expectation: A firm establishes long objectives which are pursued in successive, short run steps in future period of time. A budget is means to achieve these goals by maintaining relationship between short run goals & long run. Objectives of firm. It helps to clarify assumptions underlying future goals.

2. Planning: It is essential to accomplish goals. It reduces uncertainty and provides directors to employees by determining course of actions in advance. Budgeting compiles management to plan in a comprehensive way. Planning involves what should be done, how goals may responsibility and be held accountable.

3. Communication: The people of an enterprise should know what goals are, they should understand and support them. Top management communicates budget to lower level so as to make them clear what is to be achieved.

4. Coordination: To implies proper balance b/w labour, material & other resources so that goals are attained at min cost. The activities of various departments must remain in harmony with each other.

5. Control: It consists of action necessary to ensure that performance of org. conforms to plans and objectives. Control of performance is possible with pre determined standard which are laid down in budget. Thus, budget in makes control possible by continuous comparison of actual performance with that of budget so as to report variations from budget to mgmt of corrective actions.

Q.3. What do you mean by Flexible Budget?

Ans. **Flexible Budget:** The Flexible budget is such budget which shows the position of costs. It presents sales and profits at various levels of business activity, i.e., various volumes of outputs and sales.

Some of its definitions are as follows:

1. A Flexible budget may be defined as a budget which is designed to change in accordance with the level of activity attained." -I.C.M.A., London

2. "A Flexible budget is defined as a budget which by recognizing the difference between fixed, semi-fixed and variable costs, is designed to change in relation to the level of activity attained."

- I.C.F.A.I

Now, it is clear that flexible budget is not prepared for any specific level of activity, rather it presents budget estimates for different levels of activity, e.g., to prepare a budget at 60%, 75% 90% and 100% of normal capacity.

In short, a flexible budget gives different budgeted costs for different levels of activity. It is also known as 'Dynamic Budget', 'Variable Budget' or 'Sliding scale Budget'.

Q. 4. Define Responsibility Accounting.

Ans. Responsibility Accounting is concerned with the cost accumulation and reporting of costs and revenues by responsibility centres throughout the organization. It reflects the plans and actions of each of these centres by assigning particular revenues and costs to the one having the pertinent responsibility.

When responsibility of revenue and costs is assigned to one particular individual in the organization who shoulders primary responsibility for the item, some power of decision-making is also assigned to him so that he will be in the best position to influence costs, revenues and to exert control over them. Responsibility accounting thus forms a vital component of management control system in any organization.

Q. 5. What is Standard Costing?

Ans. **Standard Costing:**

Meaning and Definitions

Standard costing is a process and technique of accounting in which actual costs incurred are compared with pre-determined costs. On the basis of comparison efficiency of operation is determined and necessary corrective measures are taken if there are some variances. Some important definitions of standard costing are as follows:

1. "Standard costing is a method of ascertaining the costs whereby statistics are prepared to show: (a) the Standard Cost; (b) the actual costs; (c) the difference between these costs; which is termed as variance."

- H. J. Wheldon

2. "Standard costing is a technique of accounting which compares the standard cost of each product or service with the actual costs, to determine the efficiency of the operations so that any remedial action may be taken immediately." Brown & Howard

3. "Standard costing is the operation and use of standar costs, their comparison with actual costs and analysis of variance to show their cause and points of incidence."

Q. 6. Discuss the objectives of standard costing.

Ans. **Objectives of Standard Costing:**

According to W. Stretche the primary objective of standardized costing is to depict th cost of production in conditions of maximurn efficiency on eve step of production and cost so obtained is compared with actu cost given by accounts, so that variance can be ascertain between standard cost and actual cost and improvement measur should be taken to control costs.

From the analysis of description given above primary objects of standard cost system can be as follows:

1. To control all the elements of the cost of production.
2. To maintain maximum efficiency of organization and increase it.
3. To maintain efficiency and productivity factors of production.
4. To maintain similarities between costs after removing variances between standard costs and actual costs.
5. To eliminate waste expenditure and inefficiency.
6. To develop cost consciousness amongst employees.
7. To maintain feeling responsibility in case of Authority delegation.

Q.7. Write causes of labour time variance & material price variance.

Ans. Causes of Labour Time Variance: If the actual hours worked are less or more than standard hours, the difference is known as labour efficiency variance. This variance may be unfavorable on account of following causes:

- i) Use of Sub-Standard materials requiring extra labour,
- ii) Defective working conditions,
- iii) Lack of proper supervision of Work,
- iv) Use of defective machinery and equipment,
- v) Inadequate training of employees,
- vi) Discontentment among workers due to unsatisfactory working conditions, etc.

Causes of Material Price Variance:

Material price variance may arise due to following causes:

- i) Changes in market price of materials,
- ii) Failure to secure expected discount on purchases,
- iii) Failure to purchase materials at proper time,
- iv) Changes in prices of materials due to changes in tax by government,
- v) Purchasing non- standard lots and the consequent reduction in quantity discount,
- vi) Increase in transport cost due to small lot or additional transport cost for quick delivery,
- vii) Excessive shrinkage or loss in transit,
- viii) Failure to purchase the standard quality of materials.

Q 8. What do you mean by budget, budgeting and budgetary control? Discuss utility and limitations of budgetary control.

Ans.

Meaning of Budget:

The word 'Budget' is obtained from the French word 'Bougettee' which means 'a small leather bag'. The 'bag' itself is not important today. The thing the 'bag' contains is an economic bill which is presented by the Finance Minister in the Parliament every year. In this way, budget is the annual financial statement of the estimated receipts & expenditure of the government of the given period.

"A budget is a written plan covering projected activities of a firm for a defined time period".

- DICKEY

"A budget is a plan of action to achieve stated objectives based on pre-determined series of related assumption" - KELLER & FERRARE

"The budget is the fiscal plan by which expenditure may be balanced against income".

- C. L. KING

"The budget is a document containing a preliminary approved plan of public revenue & expenditure". - P. F. TAYLOR

"A budget is a comprehensive & coordinated plan, expressed in financial terms, for the operation & resources of an enterprise for some specific period in the future". JAMES

"A Budget is a financial statement prepared prior to a predetermined period of time of the policy to be persved during that period for the purpose of attaining a given objective."

-I. C. M. A., LONDON

An analysis of there definitions reveals the following essentials of a budget:

1. It is prepared for a definite future period.
2. It is a special form of statement expressed in quantitative terms which may be in the form a monetary value or physical units.
3. It is prepared with a view to attain a definite objective or target.
4. It expresses the desired plans and policies of the management to be pursued in future.
5. It provides a base for measuring the success of actual results.
6. It provide a mean of co-ordination of business as a whole.
7. It helps to ix responsibilities & direct to profitable direction.
8. It provide yardstick for comparison from other concerns.

Meaning of Budgeting:

Budgeting is a part of management process which includes preparation of budget, budget control, budget co-ordination and all those activities that are related with budget.

In other words we can say that, Budgeting refers to the management action of formulating budgets. Preparation of Budgeting is a planning function & their application or implementation is a control function.

"Budgeting may be said to be the act of building budgets". Rowland & Harr

"Budgeting is a kind of future tense according in which the problems of future are met on paper before the transactions actually occur." - William J. Batty

"Budgeting is preparation of comprehensive operating and financial plans for specific intervals of time." - Shilinglaw

Thus, it is clear that budgeting is a wider process which includes all preparations related to budget, decisions related to various problems arising in budget, implementation of budget and control on the basis of budget.

Meaning of Budgetary Control:

Budgetary Control is the process of determining various budgeted figures for the enterprises for the future period & than comparing the budgeted figures with the actual performance for calculating variances, if any. First of all budgets are prepared and then actual results are recorded.

The comparison of budgeted and actual figures will enable the management to find out discrepancies and take remedial measures at a proper time. The budgetary control is a continuous process which helps in planning and co-ordination. It provides a method of control too. A budget is a means and budgetary control is the end-result.

"A system which uses budgets as a means of planning & controlling all aspects of producing and/or selling commodities & services". - BATTY

Characteristics of Budgetary Control:

- 1. Establishment:** Budgets are prepared for each department & then the plans & objectives are prepared before the management.
- 2. Co-Ordination:** The Budgetary Control Co-ordinates the plant of various departments & master budget is prepared.
- 3. Continuous Comparison:** The essential feature of budgetary control is to conduct continuous comparison of actual performance with budgeted figures, revealing the variations
- 4. Revision:** Budgets are revised, if necessary, according to changed conditions.

Objectives of Budgetary Control:

1. To ensure planning for future by setting up various budgets The requirements & expected performance of the enterprise are anticipated.
2. To co-ordinate the activities of different departments.
3. Elimination of wastes & increase in profitability.
4. To anticipate Capital expenditure for future.
5. To centralize the control system.

Q 9. Explain the concept, features and objectives of Responsibility Accounting?

Ans.

Meaning of Responsibility Accounting:

Responsibility accounting is a management control system based on the principles of delegating and locating responsibility. The authority is delegated on responsibility centre and accounting for the responsibility centre. Responsibility accounting is a system under which managers are given decisions making authority and responsibility for each activity occurring within a specific area of the company. Under this system, managers are made responsible for the activities of segments.

These segments may be called departments, branches or divisions etc., one of the uses of management accounting is managerial control. Among the control techniques "responsibility accounting" has assumed considerable significance. While the other control devices are applicable to the organization as a whole, responsibility accounting represents a method of measuring the performance of various divisions of an organization.

The term 'division' with reference to responsibility accounting is used in general sense to include any logical segment, component, sub-component of an organization. Defined in this way, it includes a decision, a department, a branch office, a service centre, a product line, a channel of distribution, for the operating performance it is separately identifiable and measurable is somewhat of practical significance to management.

Robert Anthony defines responsibility accounting as that type of management accounting which collects and reports both planned and actual accounting information in terms of responsibility centers.

According to Charles T. Horngren, Responsibility Accounting or profitability accounting or activity accounting which means the same thing, is a system that recognizes various decision or responsibility centers throughout the organization and traces costs (and revenue, assets and liabilities) to the individual managers who are primarily responsibility for making decisions about the costs in question.

Significance of Responsibility Accounting:

The significance of responsibility accounting for management can be explained in the following way:

Easy Identification:

It enables the identification of individual managers responsible for satisfactory or unsatisfactory performance.

Motivational Benefits:

If a system of responsibility accounting is implemented, considerable motivational benefits are assured.

Data Availability:

A mechanism for presenting performance data is provided. A framework of managerial performance appraisal system can be established on that basis, besides motivating managers to act in the best interests of the enterprise.

Ready-hand Information:

Relevant and up to the minutes information is made available which can be used to estimate future costs and or revenues and to fix up standards for departmental budgets.

Planning and Decision Making:

Responsibility accounting helps not only in control but in planning and decision making too.

Delegation and Control:

The twin objectives of management are delegating responsibility while retaining control are achieved by adoption of responsibility accounting system.

Principles of responsibility Accounting

The main features of responsibility accounting are that it collects and reports planned and actual accounting information about the inputs and outputs of responsibility accounting.

Inputs and outputs:

Responsibility accounting is based on information relating to inputs and outputs. The resources used are called inputs. The resources used by an organization are essentially physical in nature such as quantity of materials consumed, hours of labour and so on. For managerial control, these heterogeneous physical resources are expressed in monetary terms they are called cost. Thus, inputs are expressed as cost. Similarly, outputs are measured in monetary terms as "revenues". In other words, responsibility accounting is based on cost and revenue data or financial information

Objectives of Responsibility Accounting :

Responsibility accounting is a method of dividing the organizational structure into various responsibility centers to measure their performance. In other words responsibility accounting is a device to measure divisional performance measurement may be stated as under:

1. To determine the contribution that a division as a sub-unit makes to the total organization.
2. To provide a basis for evaluating the quality of the divisional managers performance. Responsibility accounting is used to measure the performance of managers and it therefore, influence the way the managers behave.
3. To motivate the divisional manager to operate his division in a manner consistent with the basic goals of the organization as a whole.

Q.10. Define and explain standard costing. What are the different types of Standards? Explain them.

Ans. Standard costing is one of the most important techniques of management accounting and control. In this era of competition every manufacturer wants that the quality should be as per standard specified but cost of production should be in control. Standard costing proves a useful tool in achieving both these objectives.

Meaning of Standard:

In the context of management accounting 'standard' may be defined as measurable quantity of material, labour and other elements of cost required in production of predetermined quality, level or technical characteristics.

According to Prof. Eric L. Kohler, "Standard is a desired attainable objective, a performance, a goal, a model."

Standard Cost: Standard cost is a pre determined cost that should be attained under a given set of operating conditions. The object of standard cost is to ascertain the quotation & determination of price policy. It is a technique of cost control.

According to I.C.M.A., London, "Standard cost is the predetermined cost based on a technical estimate for materials, labour & overhead for a selected period of time & for a prescribed set of working conditions."

According to BATTY, "Standard costs represent anticipated costs under given conditions & for an expected volume of output"

According to BROWN & HOWARD, "Standard cost is a predetermined cost which determines what each product or service should cost under given circumstances."

Standard Costing: Standard costing is simply the name given to a technique whereby standard costs are computed & subsequently compared with the actual costs to determine the efficiency of the operations, so that any remedial action may be taken immediately.

According to I.C.M.A. London, Standard costing is the preparation of standard costs, their comparison with actual costs & the analysis of variances to their causes & points of incidence." According to BROWN & HOWARD, "Standard costing is a technique of accounting which compares the standard cost of each product or service with the actual costs, to determine the efficiency of the operation so that any remedial action may be taken immediately."

According to H. J. WHELDON, "standard costing is a method of ascertaining the costs whereby statistics are prepared to show-

- a) The actual cost
- b) The stand cost
- c) The difference between these costs, which is termed as variance.

Setting the Standard:

1. There must be standard committee, similar to Budget committee, in which Purchase Manager, Personnel Manager & Production Manager are represented. The cost account co-ordinates the functions of the standard committee.

2. Determine the type of standards to be used.
3. Fix standard for each element of cost.
4. Determine standard costs for each product.
5. Fix the responsibility for setting standards.
6. Classify the accounts properly so that variances may be accounted for in the manner desired.
7. Comparison of actual costs with pre-determined standards to ascertain the deviations.
8. Action to be taken by management to ensure that adverse variances are not repeated



BUDDHA SERIES

(Unit Wise Solved Question & Answers)

Course – BBA 2nd Sem

College – Buddha Institute of Management

(DDU Code-1212)

Department: Business Administration

Subject: Management Accounting

Faculty Name: Dr. Rama Raman Pandey

Unit-4

Q.1. What do you mean by financial statement analysis?

Answer: Meaning of Analysis of Financial Statements

The process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysis'.

It is basically a study of relationship among various financial facts and figures as given in a set of financial statements, and the interpretation thereof to gain an insight into the profitability and operational efficiency of the firm to assess its financial health and future prospects.

The term 'financial analysis' includes both 'analysis and interpretation'. The term analysis means simplification of financial data by methodical classification given in the financial statements. Interpretation means explaining the meaning and significance of the data. These two are complimentary to each other. Analysis is useless without interpretation, and interpretation without analysis is difficult or even impossible.

Q.2. Explain the significance of financial statement analysis.

Answer: Significance of Analysis of Financial Statements

Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the various items of the balance sheet and the statement of profit and loss. Financial analysis can be undertaken by management of the firm, or by parties outside the firm, viz., owners, trade creditors, lenders, investors, labour unions, analysts and others. The nature of analysis will differ depending on the purpose of the analyst.

A technique frequently used by an analyst need not necessarily serve the purpose of other analysts because of the difference in the interests of the analysts.

Financial analysis is useful and significant to different users in the following ways:

(a) Finance manager: Financial analysis focusses on the facts and relationships related to managerial performance, corporate efficiency, financial strengths and weaknesses and creditworthiness of the company. A finance manager must be well-equipped with the different tools of analysis to make rational decisions for the firm. The tools for analysis help in studying accounting data so as to determine the continuity of the operating policies, investment value of the business, credit ratings and testing the efficiency of operations. The techniques are equally important in the area of financial control, enabling the finance manager to make constant reviews of the actual financial operations of the firm to analyze the causes of major deviations, which may help in corrective action wherever indicated.

(b) Top management: The importance of financial analysis is not limited to the finance manager alone. It has a broad scope which includes top management in general and other functional managers. Management of the firm would be interested in every aspect of the financial analysis. It is their overall responsibility to see that the resources of the firm are used most efficiently and that the firm's financial condition is sound.

(c) Trade payables: Trade payables, through an analysis of financial statements, appraises not only the ability of the company to meet its short-term obligations, but also judges the probability of its continued ability to meet all its financial obligations in future. Trade payables are particularly interested in the firm's ability to meet their claims over a very short period of time. Their analysis will, therefore, evaluate the firm's liquidity position.

(d) Lenders: Suppliers of long-term debt are concerned with the firm's long term solvency and survival. They analyze the firm's profitability over a period of time, its ability to generate cash, to be able to pay interest and repay the principal and the relationship between various sources of funds (capital structure relationships). Long-term lenders analyse the historical financial statements to assess its future solvency and profitability.

(e) Investors: Investors, who have invested their money in the firm's shares, are interested about the firm's earnings. As such, they concentrate on the analysis of the firm's present and future profitability. They are also interested in the firm's capital structure to ascertain its influences on firm's earning and risk. They also evaluate the efficiency of the management

and determine whether a change is needed or not. However, in some large companies, the shareholders' interest is limited to decide whether to buy, sell or hold the shares.

(f) Labour unions: Labour unions analyse the financial statements to assess whether it can presently afford a wage increase and whether it can absorb a wage increase through increased productivity or by raising the prices.

(g) Others: The economists, researchers, etc., analyse the financial statements to study the present business and economic conditions. The government agencies need it for price regulations, taxation and other similar purposes.

Q.3. Describe the objectives of financial statement analysis.

Answer: Objectives of Analysis of Financial Statements

Analysis of financial statements reveals important facts concerning managerial performance and the efficiency of the firm. Broadly speaking, the objectives of the analysis are to apprehend the information contained in financial statements with a view to know the weaknesses and strengths of the firm and to make a forecast about the future prospects of the firm thereby, enabling the analysts to take decisions regarding the operation of, and further investment in the firm. To be more specific, the analysis is undertaken to serve the following purposes (objectives):

- To assess the current profitability and operational efficiency of the firm as a whole as well as its different departments so as to judge the financial health of the firm.
- To ascertain the relative importance of different components of the financial position of the firm.
- To identify the reasons for change in the profitability/financial position of the firm.
- To judge the ability of the firm to repay its debt and assessing the short-term as well as the long-term liquidity position of the firm.

Through the analysis of financial statements of various firms, an economist can judge the extent of concentration of economic power and pitfalls in the financial policies pursued. The analysis also provides the basis for many governmental actions relating to licensing, controls, fixing of prices, ceiling on profits, dividend freeze, tax subsidy and other concessions to the corporate sector.

Q.4. Explain the tools of financial statement analysis.

Answer: **Tools of Analysis of Financial Statements**

The most commonly used techniques of financial analysis are as follows:

1. Comparative Statements: These are the statements showing the profitability and financial position of a firm for different periods of time in a comparative form to give an idea about the position of two or more periods. It usually applies to the two important financial statements, namely, balance sheet and statement of profit and loss prepared in a comparative form. The financial data will be comparative only when same accounting principles are used in preparing these statements. If this is not the case, the deviation in the use of accounting principles should be mentioned as a footnote. Comparative figures indicate the trend and direction of financial position and operating results. This analysis is also known as 'horizontal analysis'.

2. Common Size Statements: These are the statements which indicate the relationship of different items of a financial statement with a common item by expressing each item as a percentage of that common item. The percentage thus calculated can be easily compared with the results of corresponding percentages of the previous year or of some other firms, as the numbers are brought to common base. Such statements also allow an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. Thus, common size statements are useful, both, in intra-firm comparisons over different years and also in making inter-firm comparisons for the same year or for several years. This analysis is also known as 'Vertical analysis'.

3. Trend Analysis: It is a technique of studying the operational results and financial position over a series of years. Using the previous years' data of a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data. The trend percentage is the percentage relationship, in which each item of different years bear to the same item in the base year. Trend analysis is important because, with its long run view, it may point to basic changes in the nature of the business. By looking at a trend in a particular ratio, one may find whether the ratio is falling, rising or remaining relatively constant. From this observation, a problem is detected or the sign of good or poor management is detected.

4. Ratio Analysis: It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm. As a technique of financial analysis, accounting ratios measure the comparative significance of the individual items of the income and position statements. It is possible to assess the profitability, solvency and efficiency of an enterprise through the technique of ratio analysis.

5. Cash Flow Analysis: It refers to the analysis of actual movement of cash into and out of an organization. The flow of cash into the business is called as cash inflow or positive cash flow and the flow of cash out of the firm is called as cash outflow or a negative cash flow. The difference between the inflow and outflow of cash is the net cash flow. Cash flow statement is prepared to project the manner in which the cash has been received and has been

utilised during an accounting year as it shows the sources of cash receipts and also the purposes for which payments are made. Thus, it summarizes the causes for the changes in cash position of a business enterprise between dates of two balance sheets.

Q.5. Discuss the limitations of financial statement analysis.

Answer:

Limitations of Financial Analysis

Though financial analysis is quite helpful in determining financial strengths and weaknesses of a firm, it is based on the information available in financial statements. As such, the financial analysis also suffers from various limitations of financial statements. Hence, the analyst must be conscious of the impact of price level changes, window dressing of financial statements, changes in accounting policies of a firm, accounting concepts and conventions, personal judgement, etc.

Some other limitations of financial analysis are:

1. Financial analysis does not consider price level changes.
2. Financial analysis may be misleading without the knowledge of the changes in accounting procedure followed by a firm.
3. Financial analysis is just a study of reports of the company.
4. Monetary information alone is considered in financial analysis while non-monetary aspects are ignored.
5. The financial statements are prepared on the basis of accounting concept, as such, it does not reflect the current position.

compared to the previous years' ratio's to see the progress of the company. This is known as trend analysis.

Q.8. Explain the advantages and limitations of ratio analysis.

Answer: **Advantages of Ratio Analysis**

When employed correctly, ratio analysis can be useful for overcoming many problems of the firm and also to highlight some positives. Ratios are essentially whistleblowers, they draw the managements attention towards issues needing attention. Let us take a look at some advantages of ratio analysis.

- Ratio analysis will help validate or disprove the financing, investment and operating decisions of the firm. They summarize the financial statement into comparative figures, thus helping the management to compare and evaluate the financial position of the firm and the results of their decisions.
- It simplifies complex accounting statements and financial data into simple ratios of operating efficiency, financial efficiency, solvency, long-term positions etc.
- Ratio analysis help identify problem areas and bring the attention of the management to such areas. Some of the information is lost in the complex accounting statements, and ratios will help pinpoint such problems.
- Allows the company to conduct comparisons with other firms, industry standards, intra-firm comparisons etc. This will help the organization better understand its fiscal position in the economy.

Ratio Analysis Limitations

While financial ratios are very important tools of financial analysis, they d have some limitations, such as

- The firm can make some year-end changes to their financial statements, to improve their ratios. Then the ratios end up being nothing but window dressing.
- Ratios ignore the price level changes due to inflation. Many ratios are calculated using historical costs, and they overlook the changes in price level between the periods. This does not reflect the correct financial situation.
- Accounting ratios completely ignore the qualitative aspects of the firm. They only take into consideration the monetary aspects (quantitative)
- There are no standard definitions of the ratios. So firms may be using different formulas for the ratios. One such example is Current Ratio, where some firms take into consideration all current liabilities but others ignore bank overdrafts from current liabilities while calculating current ratio
- And finally, accounting ratios do not resolve any financial problems of the company. They are a means to the end, not the actual solution.

Q.9. What is liquidity ratio? What are its types?

Answer: **Liquidity Ratios**

Also known as Solvency Ratios, and as the name indicates, it focuses on a company's current assets and liabilities to assess if it can pay the short-term debts. The three common liquidity ratios used are current ratio, quick ratio, and burn rate. Among the three, current ratio comes in handy to analyze the liquidity and solvency of the start-ups.

S. No.	RATIOS	FORMULAS
1	Current Ratio	Current Assets/Current Liabilities
2	Quick Ratio	Liquid Assets/Current Liabilities
3	Absolute Liquid Ratio	Absolute Liquid Assets/Current Liabilities

Q.10. What is profitability ratio? How these ratios can be calculated?

Answer: **Profitability Ratios**

These ratios analyze another key aspect of a company and that is how it uses its assets and how effectively it generates the profit from the assets and equities. This also then gives the analyst information on the effectiveness of the use of the company's operations.

S. No.	RATIOS	FORMULAS
1	Gross Profit Ratio	$\text{Gross Profit} \times 100 / \text{Net Sales}$
2	Operating Cost Ratio	$\text{Operating Cost} \times 100 / \text{Net Sales}$
3	Operating Profit ratio	$\text{Operating Profit} \times 100 / \text{Net Sales}$
4	Net Profit Ratio	$\text{Operating Profit} \times 100 / \text{Net Sales}$
5	Return on Investment Ratio	$\text{Net Profit After Interest And Taxes} \times 100 / \text{Shareholders Funds}$
6	Return on Capital Employed Ratio	$\text{Net Profit after Taxes} \times 100 / \text{Gross Capital Employed}$
7	Earnings Per Share Ratio	$\text{Net Profit After Tax \& Preference Dividend} / \text{No of Equity Shares}$
8	Dividend Pay Out Ratio	$\text{Dividend Per Equity Share} \times 100 / \text{Earning Per Equity Share}$
9	Earning Per Equity Share	$\text{Net Profit after Tax \& Preference Dividend} / \text{No. of Equity Share}$
10	Dividend Yield Ratio	$\text{Dividend Per Share} \times 100 / \text{Market Value Per Share}$
11	Price Earnings Ratio	$\text{Market Price Per Share Equity Share} \times 100 / \text{Earning Per Shar}$



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Unit-5

Q.1. Define fund flow statement.

Answer: **Funds Flow Statement**

The word funds could mean either of two things: cash or working capital. Cash will include cash at bank, cash in hand and perhaps short-term investments; while working capital is the excess of current assets over current liabilities. The preparation of a Funds Flow Statement depends on what meaning of the term Funds is being used.

Funds flow statement is a statement which discloses the analytical information about the different sources of a fund and the application of the same in an accounting cycle. It deals with the transactions which change either the amount of current assets and current liabilities (in the form of decrease or increase in working capital) or fixed assets, long-term loans including ownership fund.

Fund flow statement is a statement which shows the movement of funds and report of the financial operations of the enterprise. It shows various means by which funds are obtained and where the same are used.

Rober N. Anthony—The fund flow statement describes the sources from which additional funds were derived and the use to which these sources were put to use.

ICWA. It is a statement either prospective or retrospective, setting out the sources and application of the funds of the enterprise. The purpose of the statement is to indicate how funds are raised and how the same have been utilized.

There are three statement prepared in fund flow statement namely: Schedule/Statement of changes in working capital, Fund from operation and fund flow statement.

Q.2. What is schedule of change in working capital? Prepare a specimen of the same.

Answer: Schedule/Statement of changes in working capital

The information relating to the changes in current natured accounts between two periods of time presented in the form of a statement is what we call the schedule/statement of changes in working capital.

Since a funds flow statement depicts changes in working capital, it will be better to prepare first the schedule of changes in working capital before preparing a Funds Flow Statement.

The statement of changes in working capital or simply called “working capital statement” is prepared with the help of current assets and current liabilities. There is no effect of additional information given separately, and such information will affect only the funds flow statement.

Statement of Changes in Working Capital				
	Previous Year Rs.	Current Year Rs.	Effect of Change on Working capital	
			Increase Rs.	Decrease Rs.
Current Assets				
Cash				
Bank				
Stock				
Prepaid expenses				
Total (a)				
Current Liabilities:				
Outstanding expenses				
B/P				
Creditors				
Total (b)				
Working capital (a-b)				
Net increase/decrease in working capital				

Q.3. What do you mean by fund from operations? Explain its methods of preparation.

Answer: Fund from operation

Funds from operations is the cash flows generated by the operations of a business. This measure is commonly used to judge the operational performance of business.

(a) Added-Back Method:

Most of the annual reports follow this method and compute “Funds from Operation” simply by adjusting the figures relating to earnings for the items which do not affect the funds, although these are included in Profit and Loss Account.

The same is outlined as:

Calculation of Funds from Operation:

	Rs.
Net Profit (during the year)	***
<i>Add: Non Cash Items/Charges/Non-Trading Charges</i>	
(a) Depreciation	***
(b) Amortisations of Fictitious/Intangible Items, e.g.	***
(i) Patent	***
(ii) Goodwill	***
(iii) Preliminary Expenses	***
(iv) Discount on issue of Shares, Debentures	***
(v) Trademarks etc.	***
(c) Loss on Sale of Fixed/Non-Current Assets	***
(i) Loss on sale of Plant and Machinery	***
(ii) Loss on sale of Land and Building	***
(iii) Loss on sale of Investment	***
(iv) Loss on sale of Furniture, etc.	***

Contd.

		Rs.
(d) Transfer to		
(i) General Reserve	* * *	
(ii) Sinking Fund	* * *	
(iii) Dividend Equalisation Fund	* * *	
(iv) Contingency Reserve	* * *	
(v) Any fund which is an appropriation of profit	* * *	
(e) Dividends		
(i) Proposed Dividend	* * *	
(ii) Interim Dividend	* * *	
(iii) Provision for Taxation (if not taken as a current liability)	* * *	
(iv) Any other non-fund items	* * *	
	* * *	
		* * *
<i>Less: Non-operating Incomes:</i>		
(a) Profit on sale of Fixed Assets, e.g. Plant and Machinery, Land and Building, Furniture and Fittings, Investment etc.	* * *	
(b) Appreciation in the value of assets	* * *	
(c) Excess profit to be written-back (i.e. excess provision for bad debts)	* * *	
(d) Income from non-trading assets (i.e., investment, etc.)	* * *	
(e) Dividend Received	* * *	
(f) Any other non-operating Income	* * *	
	* * *	
Funds from Operations		* * *

(b) Direct Method:

This takes the form of a final account of a company. It takes into consideration each item of revenue income and revenue expenditure individually which affect funds from operation, i.e. the items which affect funds. So, items like depreciation, provision for bad debts, write-off, etc. will not appear here at all.

The outline of such a Profit and Loss Account can be depicted as:

Proforma Profit and Loss Account			
Dr.		Cr.	
To Raw Materials Consumed	Rs.	By Sales	Rs.
" Wages	√		√
" Power & Fuel	√		
" Factory Expenses	√		
" Office and Administration Expenses	√		
" Directors' Fees	√		
" Audit Fees, etc.	√		
" Funds from Operation or Trading Profit (bal. fig.)	√		
	√		√

Q.4. Explain the objectives and usefulness of fund flow statement.

Answer: Objectives and Uses of Fund Flow Statement

1. Knowledge of Financial Position: The fund flow statement indicates the addition in profits which is a boon to the shareholders. The division of profit can be planned.

2. Knowledge of addition in share capital: The fund flow statement can highlight the changes in share capital. What is the need of increase in share capital and where the same have been used?

3. Knowledge of Addition or Reduction in Share Premium: The fund flow statement clearly shows the fluctuation in share premium. It is increased when shares are issued at premium when preferential shares or debentures are reduced, the premium it will reduce both position can be seen from this statement.

4. Knowledge of profit or loss of operation: The fund flow statement can easily show whether the organization is earning profit or going into loss.

5. Knowledge of addition in long term Borrowings: This statement can show the additional amount borrowed by issuing debentures. Why is the issue of debentures desirable?

6. Knowledge of decrease in working capital: This statement shows the reduction in working capital. It will be when current assets are less than current liabilities. It speaks about more revenues to the organization.

7. Fund flow statement acts as a guide: It also works as guide to the management. The management can know various future problems of the company. The future needs of the company can be predicted. The management can manage to raise funds effectively and can avoid financial problems of the organization.

8. Helpful in sound dividend policy: There are cases where a company having sufficient profit yet it is advisable not to distribute dividend for lack of cash or liquid. The statement of fund is useful in forming sound dividend policy.

9. Helpful in long term borrowings: The various financial institutions before advancing long term loans ask for many years fund flow statement to know the worthiness of credit of the firm.

10. Useful information to the investors: Before investing funds some investors like to study its fund flow statement to know how the funds are raised, and how these are applied, Whether funds are adequate or not for the payments of interest and principal sum?

11. Other uses of fund flow statement.

(i) It highlights whether or not sufficient funds are available for shareholders dividend.

(ii) The ability of the organization to thrust the organization for getting additional working capital.

(iii) Justification for long term borrowings.

(iv) Knowledge of sources of funds for the purchase of fixed assets.

Q.5. Describe the limitations of fund flow statement.

Answer: Limitations of Fund Flow Statement

The main limitations against fund flow statement are as under:

1. Fund flow statement is not a substitute of income statement or Balance Sheet. The only limiting factor about fund flow statement is that it is not a substitute for income statement and Balance sheet. Fund flow statement provides some other additional information regarding change in working capital.
2. It cannot state the reason why capital is raised or redeemed?
3. It is a by-product of financial statement. As a matter of fact, fund flow statement is re-arranged statement of financial data.
4. Based on historical data. Fund flow statement is historical in nature as it is the outcome of old financial data which are simply a window dressing.
5. Misleading. Fund flow statement is, sometimes misleading if an analyst does not know the reality and soundness of the figures from which they are computed.

Q.6. Prepare a proper format of fund flow statement.

Answer: **Specimen of Fund Flow Statement**

Sources of Funds	Applications of funds
1. Increases in share capital (both equity and preferential).	1. Decrease in share capital (redemption of preferential share capital).
2. Increase in share premium.	2. Reduction in share premium.
3. Increase in long term loans. (Debentures etc)	3. Redemption of debentures.
4. Income from Operations (Profit).	4. Income from Operations. (Loss).
5. Sale of fixed assets.	5. Purchase of fixed assets.
6. Decrease in working capital.	6. Increase in working capital.

Q.8. Explain the objectives of preparing a cash flow statement.

Answer: **Objectives of preparing Cash Flow Statement**

1. Cash flow statement shows inflow and outflow of cash and cash equivalents from various activities of a company during a specific period under the main heads i.e., operating activities, investing activities and financing activities.
2. Information through the Cash Flow statement is useful in assessing the ability of any enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows.
3. Taking economic decisions requires an evaluation of the ability of an enterprise to generate cash and cash equivalents, which is provided by the cash flow statement

Cash and cash equivalents generally consist of the following:

1. Cash in hand
2. Cash at bank
3. Short term investments that are highly liquid
4. Bank overdrafts comprise an integral element of the organization's treasury management

Q.9. Explain the activities of cash flow statement.

Answer:

Classification of activities:

Cash flow activities are to be classified into three categories :This is done to show separately the cash flows generated / used by these activities, thereby helping to assess the impact of these activities on the financial position and cash and cash equivalents of an enterprise.

1. Operating activities
2. Investing activities
3. Financing activities

Cash from Operating Activities:

Operating activities are the activities that comprise of the primary / main activities of an enterprise during an accounting period. For example, for a garment manufacturing company, operating activities include procurement of raw material, sale of garments, incurrence of manufacturing expenses, etc. These are the principal revenue generating activities of the enterprise.

Profit before tax as presented in the income statement could be used as a starting point to calculate the cash flows from operating activities.

Cash Inflows from operating activities:

- Cash receipts from sale of goods and rendering services.
- Cash receipts from fees, royalties, commissions and other revenues.

Cash Outflows from operating activities:

- Cash payments to suppliers for goods and services.
- Cash payments of income taxes unless they can be specifically identified with financing and investing activities.

Following adjustments are required to be made to the profit before tax to arrive at the cash flow from operations:

Elimination of non cash expenses (e.g. depreciation, amortization, impairment losses, bad debts written off, etc)

Removal of expenses to be classified elsewhere in the cash flow statement (e.g. interest expense should be classified under financing activities)

Removal of income to be presented elsewhere in the cash flow statement (e.g. dividend income and interest income should be classified under investing activities unless in case of for example an investment bank)

Elimination of non cash income (e.g. gain on revaluation of investments)

The amount of cash from operations indicates the internal solvency level of the company. It is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain its operating potential.

Cash from Investing Activities:

Cash flow from investing activities includes the movement in cash flows owing to the purchase and sale of assets. It relates to purchase and sale of long-term assets or fixed assets such as machinery, furniture, land and building, etc.

Cash Outflows from investing activities

- Cash payments to acquire fixed assets including intangibles and capitalized R&D.
- Cash advances and loans made to third party (other than advances and loans made by a financial enterprise wherein it is operating activities).
- Cash payments to acquire shares, warrants or debt instruments of other enterprises other than the instruments those held for trading purposes.

Cash Inflows from investing activities

- Cash receipt from disposal of fixed assets including intangibles.
- Cash receipt from the repayment of advances or loans made to third parties (except in case of financial enterprise).
- Dividend received from investments in other enterprises.
- Cash receipt from disposal of shares, warrants or debt instruments of other enterprises except those held for trading purposes.

Cash from Financing Activities:

It includes financing activities related to long-term funds or capital of an enterprise. Financing activities are activities that result in changes in the size and composition of the owners' capital and borrowings of the enterprise.

e.g., cash proceeds from issue of equity shares, debentures, raising long-term loans, repayment of bank loans, etc.

Cash Inflows from financing activities

- Cash proceeds from issuing shares (equity / preference).
- Cash proceeds from issuing debentures, loans, bonds and other short/ long-term borrowings.
- Cash Outflows from financing activities:

Cash repayments of amounts borrowed.

- Interest paid on debentures and long-term loans and advances.
- Dividends paid on equity and preference capital.

Q.10. Explain the methods of preparing cash flow statement.

Answer: Methods of preparing the Cash Flow Statements

Operating activities are the main source of revenues and expenditures, thereby cash flow from the same needs to be ascertained. The cash flow can be reported through two ways:

Direct method that discloses the major classes of gross cash receipts and cash payments and

Indirect method that has the net profit or loss adjusted for effects of (1) transactions of a non-cash nature, (2) any deferrals or accruals of past/future operating cash receipts and (3) items of income or expenses associated with investing or financing cash flows.

Direct method:

In the direct method, the major heads of cash inflows and outflows (such as cash received from trade receivables, employee benefits, expenses paid, etc.) are to be considered.

As the different line items are recorded on accrual basis in statement of profit and loss, certain adjustments are to be made to convert them into cash basis such as the following:

1. Cash receipts from customers = Revenue from operations + Trade receivables in the beginning – Trade receivables in the end.
2. Cash payments to suppliers = Purchases + Trade Payables in the beginning – Trade Payables in the end.
3. Purchases = Cost of Revenue from Operations – Opening Inventory + Closing Inventory.
4. Cash expenses = Expenses on accrual basis + Prepaid expenses in the beginning and Outstanding expenses in the end – Prepaid expenses in the end and Outstanding expenses in the beginning.

Indirect method:

Indirect method of ascertaining cash flow from operating activities begins with the amount of net profit/loss. This is so because statement of profit and loss incorporates the effects of all operating activities of an enterprise. However, Statement of Profit and Loss is prepared on accrual basis (and not on cash basis). Moreover, it also includes certain non-operating items such as interest paid, profit/loss on sale of fixed assets, etc.) and non-cash items (such as depreciation, goodwill to be written-off, etc. Therefore, it becomes necessary to adjust the amount of net profit/loss as shown by Statement of Profit and Loss for arriving at cash flows from operating activities.

Indirect method:		
Net profit before Tax and extra ordinary Items	xxx	
Cash flow from Operating activities		
Add: Non-cash and non-operating Items which have already been debited to profit and Loss Account like;		
Depreciation	xxx	
Amortisation of intangible assets	xxx	
Loss on the sale of Fixed assets	xxx	
Loss on the sale of Long-term Investments	xxx	
Provision for tax	xxx	
Dividend paid	xxx	xxx
Less: Non-cash and Non-operating Items which have already been credited to Profit and Loss Account like		
Profit on sale of fixed assets	(xxx)	
Profit on sale of Long term investment	(xxx)	(xxx)
Operating profit before working Capital changes (A)		xxx
Changes in working capital:		
Add: Increase in current liabilities	xxx	
Decrease in current assets	xxx	xxx
Less: Increase in current assets	(xxx)	
Decrease in current liabilities	(xxx)	(xxx)
Net increase / decrease in working capital (B)		xxx
Cash generated from operations (C) = (A+B)		xxx
Less: Income tax paid (Net tax refund received) (D)		(xxx)
Cash flow from before extraordinary items (C-D) = (E)		xxx
Adjusted extraordinary items (+/-) (F)		xxx
Net cash flow from operating activities (E+F) = (G)		xxx
Cash flow from Investing activities		

Indirect method:		
Proceeds from sale of fixed assets	xxx	
Proceeds from sale of investments	xxx	
Purchase of shares/debentures/fixed assets	(xxx)	
Net cash from investing activities (H)		xxx
Cash flow from Financing activities		
Proceeds from issue of shares	xxx	
Proceeds from issue of debentures	xxx	
Payment of dividend	(xxx)	
Net cash flow from financing activities (I)		xxx
Net increase in cash and cash equivalents (G+H+I) = (J)		xxx
Cash and cash equivalents and the beginning of the period (K)		xxx
Cash and cash equivalents and the end of the period (J+K)		xxx

Q.11. Explain the importance, advantages and disadvantages of cash flow statement.

Answer: Purpose & Importance of Cash Flow Statements

- Statement of cash flows provides important insights about the liquidity and solvency of a company which are vital for survival and growth of any organization.
- It enables analysts to use the information about historic cash flows for projections of future cash flows of an entity on which to base their economic decisions.
- By summarizing key changes in financial position during a period, cash flow statement serves to highlight priorities of management.
- Comparison of cash flows of different entities helps reveal the relative quality of their earnings since cash flow information is more objective as opposed to the financial performance reflected in income statement.

Advantages of Cash Flow Statement

- Cash Flow Statements help in knowing the liquidity / actual cash position of the company which funds flow and P&L are unable to specify.
- As the liquidity position is known, any shortfalls can be arranged for or excess can be used for the growth of the business
- Any discrepancy in the financial reporting can be gauged through the cash flow statement by comparing the cash position of both.
- Cash is the basis of all financial operations. Therefore, a projected cash flow statement will enable the management to plan and control the financial operations properly.
- Cash Flow analysis together with the ratio analysis helps measure the profitability and financial position of business.
- Cash flow statement helps in internal financial management as it is useful in formulation of financial plans.

Disadvantages of Cash Flow Statement

- Through the cash flow statement alone, it is not possible to arrive at actual P&L of the company as it shows only the cash position. It has limited usage and in isolation it is of no use and requires BL, P&L for its projections. Cash flow statement does not disclose net income from operations. Therefore, it cannot be a substitute for income statement
- The cash balance as shown by the cash flow statement may not represent the real liquidity position of the business because it can be easily influenced by postponing the purchases and other payments
- Cash flow statement cannot replace the funds flow statement. Each of the two has a separate function to perform.