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ACCOUNTING AND FINANCE FOR MANAGERS

By: *Ankita Aggarwal*,
M.B.A.

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ACCOUNTING FRAMEWORK

UNDERSTANDING FINANCIAL STATEMENTS

■■

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QUESTION PAPER

(June – 2019)

(Solved)

ACCOUNTING AND FINANCE FOR MANAGERS

Time: 3 hours] *[Maximum Marks: 100*

Note: *Attempt* ***any five*** *questions. All Questions carry* ***equal*** *marks.*

Q. 1. ***(a)*** **What do you understand by the Concept of Conservatism? Why is it also called the concept of prudence? Why is it not applied as strongly today as it used to be in the past? Discuss.**

Ans. Ref: See Chapter-2, Page No. 12, 'The Concept of Conservation'.

Also Add: The prudence concept, also known as the conservatism principle, is an accounting principle that requires an accountant to record liabilities and expenses as soon as they occur, but revenues only when they are assured or realized. The prudence concept requires the accountants to be cautious in the adoption of policies and estimations in such a way that the entity's income and assets are not overstated and the entity's expenses and liabilities are not understated.

Under the prudence concept, the company should not recognize a particular asset at a value higher than the amount that can be recovered from its use or sale. In the same way, liabilities should not be recognized by the company at a lower value than the amount they are expected to be paid for in the future.

The application of the prudence concept in accounting eliminates bias from financial reports and statements; however, it should not affect the reliability of the presented information. For example, inventory is recorded in the financial records of a company at the net realizable value, or NRV, and not the actual expected price of selling. This ensures that the profit from the sale is realized when the sale takes place.

The principle of conservatism or prudence states that the business as an entity should prepare and anticipate for all possible losses and should always expect the situation to be such that the gains will be minimal. This is for the purpose of providing for unexpected losses and absorbing the shock from the same. It is still used by businesses, but they are assuming more and more risk and retaining lesser for such contingencies.

(b) **Distingiush between Financial Accounting and Management Accounting. Explain the purposes which they serve and interconnection between them.**

Ans. Ref: See Chapter-1, Page No. 9, Q.No. 7.

Also Add: Management and Accounting have been closely associated for a long time. Historically, the functions of accounting have been to record, analyze, and report the results of business operations in various units of measurement, such as rupees, units of production, standard hours and kilowatts.

The management accountant's purpose is to provide information for one user the firm's management; the financial accountant's purpose is to provide information for a variety of users. Managerial accounting and the functions of planning, controlling, decision-making and analyzing with the use of accounting data.

1. Planning: Business budgets are the principal financial means by which the manager can formalize and express a plan. Moreover, once budgets are established, they serve as a control technique by setting pre-determined criteria against which managers can compare actual results. In addition, the budgeting process serves as a tool for coordinating the activities of various functions and operating segments of the firm.

In Figure ahead shows that comprehensive budgeting consists of a number of budgets with the sales budget, based upon a sales forecast, usually serving as the starting point in the process. The production budget is based on the sales budget and, all others are, in turn, constructed on consistent assumptions concerning the future.

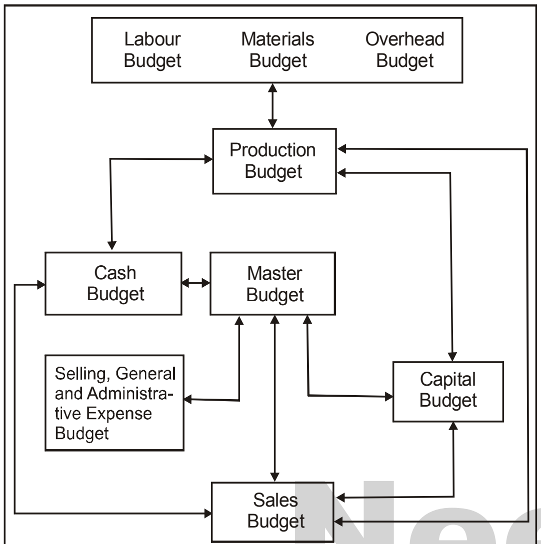

Fig. Budgeting

2. Control: Control involves the comparison of actual performance with some predetermined criterion. Obviously budgeting is a control device, because management compares the actual costs and revenues with the budgeted amounts.

3. Deciding: The manager can obtain accounting information designed to aid him in deciding between alternative courses of action in two ways:

(i) The reutilized collection of relevant data for certain types of anticipated decisions is called programmed analysis.

(ii) Non-programmed analysis develops special cost information for specific decisions.

The relevant cost information for decision-making should pertain to those costs that will be different under alternative actions not yet taken. Thus the central idea in accounting for decision-making (whether programmed or non-programmed) is the incremental concept – that is – the analysis of changes in total costs and in total revenues.

4. Analysis of Past Performance: Financial accounting statements contain valuable information that managers can use to analyse past performance.

(i) Comparisons of two or more periods, and

(ii) Comparison within one period.

The former includes the analysis of successive balance sheets and income statements to deter-mine trends in individual items. The latter involves the analysis of current financial statements to determine the state of the firm with respect to its solvency, stability and profitability. Another very useful technique of the managerial accountant is called source and application of funds analysis.

This technique involves the determination of where funds (working capital) have come from and how they were used, that is, a focus on cash flow. Most of the information needed for analysis can be obtained from a comparison of two balance sheets plus some supplemental information added to reflect the flow of funds. From management point of view, the value of the analysis of source and use of funds is that it gives valuable insight on the efficiency of management in allocating funds.

Q. 2. Discuss the importance of cash and cash flow statement. How is the length of the cash cycle determined? How does the length of the cash cycle affect the requirement of working capital of a firm? Discuss.

Ans. The importance of cash and cash flow statement along with examples:

***(a)* Helps to make Cash Forecast:** Cash Flow Statement, no doubt, helps the management to make a cash forecast for the near future. A projected Cash Flow Statement helps the management about the cash position which is the basis for all operations and, thus, the management sees light relating to cash position, viz. how much cash is needed for a specific purpose, sources of internal and external issues, etc.

***(b)* Helps the Internal Management:** It helps the internal management to determine the financial policy to be adopted in future since it supplies information relating to funds, e.g. taking decision about the replacement of fixed assets or repayment of long-term liabilities, etc.

***(c)* Reveals the Cash Position:** It is a significant pointer about the movement of cash, i.e. whether there is any increase in cash or decrease in cash and the reasons thereof which helps the management. Moreover, it explains the reasons for small cash balance even though there is sufficient profit, or vice

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The Chapter

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ACCOUNTING AND FINANCE FOR MANAGERS

ACCOUNTING FRAMEWORK

Accounting and its Functions

1

INTRODUCTION

Accounting has been defined in different ways by different authors and authorities. There is no unaminity among them because the concept of accounting has to be changed with the passage of time. On the basis of functions, accounting may be defined as the art of recording, classifying and summarising business transactions of a financial character and interpreting and communicating the results to the users to enable them to make decisions. Accounting is concerned with the recording of transactions which are measurable in monetary terms in such a way that analysis and interpretation of business acitivities are possible. According to the latter definition of accounting is concerned with the recording of business transactions for better management of the concern and also reporting the true financial position of the concern.

The American Accounting Association (AAA) defines accounting as *"the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information"*.

CHAPTER AT A GLANCE

SCOPE OF ACCOUNTING

The scope of accounting can be explained in diagrammatic form:

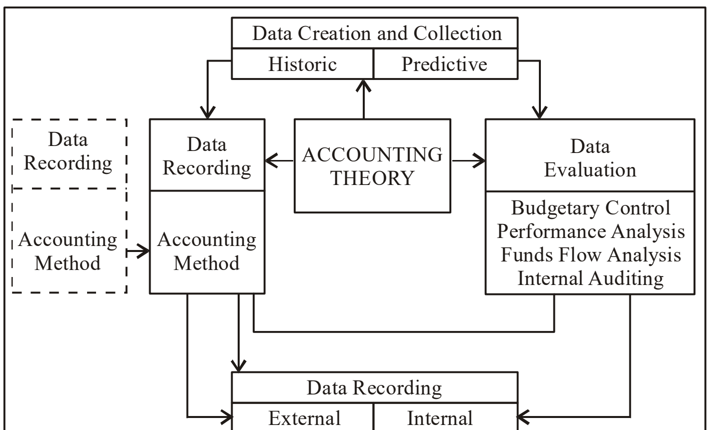

Fig. Scope of Accounting

Data creation and collection

This area deals with providing the raw material for the accounting. The historic data collected refers to events which have already taken place. In early times, accounting was concerned with what had happened, rather than making attempt to predict the future and prepare for it. After collecting the historic data, it is recorded in accordance with generally accepted accounting theory. According to the classification scheme, a large number for transactions are added in the books of journals and ledgers. The substantial part of the total accounting work is the recording and processing of information. The processing method of recording can be manual, mechanical or electronic.

Data evaluation

The most important activity in accounting includes controllong the activities of business with the help of budgets and standard cost, evaluating the performance of business, analysing the flow of funds and analysing the accounting information for decision making purpose by choosing among alternative courses of action.

The analytical interpretive work of accounting

It can be used internally or externally and may range from sharp answers to elaborate reports produced by extensive research. Research based projects include capital project analysis, financial forecasts, budgetary projections and analysis for re-organisation, takeover and mergers.

Data reporting

Data reports are of two types, external and internal. External reporting means communication of financial information about the business to external parties like shareholders, government agencies and regulatory bodies of government. Internal reporting goes on with the communication of results of financial analysis and evaluation to management for decision-making purposes.

EMERGING ROLE OF ACCOUNTING

The history of accounting development reflects its changing business and social needs. It indicates the evolutionary pattern which reflects changing socio-economic conditions. At present there are four phases of evolution of accounting.

***(i)* Stewardship Accounting:** In the earlier times, people who were wealthy employed stewards to manage their property. The stewards were accountable to their owners periodically. This notion lies at the base of financial reporting even today. It involves the orderly recording of business transactions, commonly known as book keeping. The practices employed by the 15^{th} century merchants of Italy are the origin of today's accounting concepts and principles. During the 19^{th} century, European countries adopted the Italian method which specifically began to be known as 'double entry book keeping'. Stewardship accounting is linked with the need of business owners to keep records of their transactions, the property, the tools they owned, debts they owed and the debts other owed them.

***(ii)* Financial Accounting:** Financial accounting involves preparation of financial reports, which provide summaries of a firm's financial condition. The main task of financial accounting is to prepare balance sheet and income statement, etc.

***(iii)* Cost Accounting:** The main purpose of cost accounting is to ascertain the cost of production of goods and cost of running different departments to enable the management to fix the selling price.

***(iv)* Management Accounting:** The main purpose of management accounting is to provide all the relevant informations that may be required by the management to take decisions in respect of various aspect for running the business enterprise. It is the tool in the hands of management for the purpose of making policy-decisions.

***(v)* Social Responsibility Accounting:** Social responsibility accounting is a new phase in the development of accounting. The reason behind its birth is the increasing social awareness which has been particularly noticeable over the last two decades or so. It considers the social effects of the business along with the economic effects which widen its scope. The social scientists, statesmen and social workers works to draw the attention of their governments and people in their countries to the dangers posed to environment and the ecology by the unbridled industrial growth. These days, the management is responsible for contribution of business to social well being and progress and not just responsible for efficient conduct of business in terms of profitability.

Some Recent Developments

Human resource accounting

The first attempt to include figures on human capital in the balance sheet was made by Hermansson in 1964, it was later known as human resource capital. In 1990s, there has been a socio-economic shift with the emergence of the knowledge economy, a distinctive shift towards recognition of human and intellectual capital contrast to physical capital.

Human resource accounting is a branch of accounting which includes reporting and emphasising the importance of human resources like knowledge, loyalty and commitment of employees. It is the process of identifying, measuring and communicating the data related to human resources to interested parties. It involves accounting for investment in people and their replacement costs as well as accounting for the economic values of people to an organization. Generally the method used for valuing and accounting for human resources are either based on costs or on economic value of human resources. However providing adequate and valid information on human assets which are outside the concept of ownership, in figures is very difficult. Nevertheless, HRA is a managerial tool providing valuable information to the top management to take decisions regarding adequacy of human resources and thus encouraging managers to consider investment in manpower in more positive way.

Inflation Accounting

Inflation accounting refers to the adjustment in the value of assets (current and fixed) and of profit in the light of changes in the price level. It is concerned with overcoming of limitations in the financial statements on accounts of the cost assumption and the assumption of stable monetary unit. Hence, it is directed at correcting the distortions in the reported results caused by price level changes. Rise in the price during inflation generally have the distortion influence of overstating the profit. Various approaches have been suggested to deal with this problem in inflation accounting.

ACCOUNTING AS AN INFORMATION SYSTEM

Accounting includes series of activities which are linked with each other i.e. collecting, recording, analysing and evaluating the data and in the last communicating information to the users. Information has no meaning unless it is linked with a certain purpose.

Accounting as a social science can be seen as an information system as it has all the features of the system. It has its input (raw data), processes (men and equipment), and outputs (reports and information). Considering accounting as an information system, we are in a position to make some important observations. First, providing information which meets the needs of the users is the aim of the system. If we can identify the needs of the users, we can specify the nature and the character of the outputs of the system. Secondly, the output requirements determine the type of data to be selected as the inputs for processing into information output.

Several groups of people having stake in a business organisation managers, shareholders, creditors, employees, customers etc. are there. Such stake holders need following type of information:

Shareholders and investors

Shareholders invest their money in the business and so they are bothered about the profitability of the enterprise, the soundness of their investment and growth prospects of the enterprise.

Creditors

There can be short-term creditors who provide raw materials, goods and services and long-term creditors who lent money for long period. Creditors are concerned about the credit worthiness of the enterprise and its ability to meet the credit obligation.

Employees

Employees have a stake in the outcomes of the several managerial decisions. They are interested in matters related to wages, bonus, and profit sharing on adequate disclosure of relevant facts.

Government

Government is responsible to direct the operation of the economic system in a way that it subserves the common good in the mixed economy. Various government agencies collect information regarding levels of outputs, profits investments, costs and taxes etc. All this information helps in evolving policies for managing the economy.

Management

Management process of all the organizations are almost same, no matter it is a profit organisation or non-profit organisation. Management process involves planning, organising, controlling etc. Managment has to perform all these functions efficiently and effectively which has considerably extended the demand for accounting information.

Consumers and others

Other people who are interested in condensed accounting information are consumer organisations, media, welfare organisation.

The community at the large has economic and social interest in the activities of such organisations. This interest is expressed at the national level by the concern of government in various aspects of the firms' activities.

ROLE AND ACTIVITIES OF AN ACCOUNTANT

Below are some statements which describe who an accountant is:

- An accountant is responsible for account keeping.
- An accountant is a functionary who aids control.
- An accountant holds the conscience of an organisation.
- An accountant is a professional whose primary duties are related to information management for internal and external use.
- An accountant is a fiscal advisor.
- An accountant produces an income statement and a balance sheet for an accounting period and maintains all supporting evidence and classified facts that lead to final accounting statements.
- An accountant verifies, authenticates and certifies accounts of an entity.

ACCOUNTING PERSONNEL

An accountant is a professional who is responsible for the processing of financial data, score keeping, attention directing and problem solving purposes. He has a persuasive role which involves a wide range of activities. There are two broad activities in which accountants are divided, those who are in public practice and those who are in private employment.

***(a)* Accountant:** Accountants may be in various business or non-business organisations to perform a variety of accounting and management control activities. Public accountants are generally member of professional bodies like the Institute of Chartered Accountants of India or the Institute of Cost and Works Accountants of India. Accountant also provides consultancy services for improving accounting and management control system in every organisation.

***(b)* Chief Accountant or Controller:** The other name for the controller is the Chief Accountant. He is usually the head of the whole area of accounting, including internal audit. He is overall in-charge of all activities like financial accounting, cost accounting, management accounting, tax accounting etc. He exercises both for accounting within the organisation and for external reporting. The external reports comprise reports to government revenue collecting and regulatory bodies, such as Company Law Board and Income tax Department. He may also be responsible for the supervision of the company's internal audit and control systems. He process historical data and is expected to supply a good deal of accounting information to top management concerning future operations, in line with the management's planning and control needs. Also, he is expected to supply detailed information to managers in different functional areas like production, marketing etc. and at different levels of an organization.

We can state the functions of the controller as follows:

- Designing and operating the accounting system
- Preparing financial statements and reports
- Establishing and maintaining systems and procedures
- Supervising internal auditing and arranging for external audit
- Supervising computer applications
- Overseeing cost control

***(c)* Treasurer:** He is the manager and the custodian of all the cash and near cash resources of the firm. The treasurer handles credit reviews and sets policy for collecting receivable. Also, he is responsible for handling the relationships with bank and other lending or financial institutions.

The Financial Executive Institute (of United States of America) makes the following distinction between controllership and treasurership functions:

Controllership	Treasurership
Planning and control	Provision of capital
Reporting and Interpreting	Investor Relations
Evaluating and Consulting	Short term Financing
Tax administration	Banking and Custody
Government Reporting	Credit and Collections
Protection of Assets	Investments
Economic Appraisal	Insurance