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2019-2020

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**UNIT-III**

**MANAGEMENT ACCOUNTING**

Accounting for management-Functions and Benefits-Analysis and Interpretation of financial statements- Ratios-Fund flow and Cash Flow-Budgetory Control.

**Definition Of Accounting:**

Accounting has been defined by the american accounting association committee as: “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information”. This may be considered as a good definition because of its focus on accounting as an aid to decision making.

**Forecasting**

It determines the bottlenecks in the organization and their impact on the organization.
Accounting can be classified into three categories:
1. Financial Accounting
2. Cost Accounting, and
3. Management Accounting

**Financial accounting:**

The term “Accounting” unless otherwise specifically stated always refers to “Financial Accounting”. Financial Accounting is commonly carried on in the general offices of a business. It is concerned with revenues, expenses, assets and liabilities of a business house. Financial Accounting has two-fold objective, viz,

1. To asceritary the profitability of the business, and
2. To know the financial position of the concern.

**Advantages of Management Accounting:**

- Companies opt for Management accounting as it increases the efficiency of company in performing operations.
- It contributes in striving for better performance by evaluating and comparing.
- Management accounting makes it easier to achieve various results.
- This indirectly motivates the employees to strive for better performance.
- As a result, they receive rewards in the form of promotions.
- Thus, management accounting indirectly increases the efficiency of the company at a whole.

**Increases the bar of Profitability:**

- Management accounting includes budgetary control and capital budgeting.
- The use of this method makes it easier for the company to cut short the extra expenditure for performing vital operations.
- This indirectly increases the bars of profits for the company, as the company is able to reduce its pricing on the products.
Simplifies the decision making in Financial Statements:

- Managerial decisions and other activities of management require a simplified report of the financial statement of the company.

- For this action, management accountant creates a detailed technical report with simpler interpretations. Here, he represents the key facts of the financial statements.

- This enables the managing officers to take up appropriate decisions for the betterment of the company.

Cost transparency:

In the corporate world, majority of the costs come from the Information Technology (IT). The work of management accounting in the firm is to work with the IT department closely. This action ensures within budget actions and provides cost transparency to the company.

Flexibility and freedom:

Management accounting system is of flexible nature. These reports do not require to be made yearly, monthly, or weekly. Therefore, the accountant gets enough time to prepare a perfect report.

Assist in goal completion (Objectives):

- The objective of the report presented by the management accountant is to assist in achieving a long-term goal.

- It becomes possible to achieve the goal due to the detailed information of the management accountant, which highlights the strong and weak points of the company.

- In addition, this information helps to identify the weakness and takes measures to overcome them.

Future prediction from past result:

- Every new system that evolves for the corporate world has a single motive.

- It is to attain success in the competitive market.

- With similar intend, management accounting system also strives for betterment in performance.

- Thus, with the help of given data of the past (of the company), it provides a chance to prepare for better future results.
Advanced technique and features:

- The reasons because of which the management system seems reliable are the special tools and technique.
- To form an accurate and valid report special techniques like budget controlling, marginal costing, control accounting, etc. are used.
- Use of the technique may differ according to the issue at hand.
- However, this technique makes it easier to make decisions in the favor of the company.

Marginal costing:

Marginal costing is possible with the aid of management accountant. It fixes the selling price of the products created in the organization. Further, it also suggests several ways to use the scarce materials and resources. It also recommends actions based on fixed cost, contribution, and other extras. Although management accounting does not promise perfect decisions, they do increase the chances of taking effective and efficient decisions.

Nature and scope of financial accounting:

Financial accounting is a useful tool to management and to external users such as shareholders, potential owners, creditors, customers, employees, and government. It provides information regarding the results of its operations and the financial status of the business.

The following are the functional areas of financial accounting:

1. Dealing with financial transactions:

   Accounting as a process deals only with those transactions which are measurable in terms of money. Anything which cannot be expressed in monetary terms does not form part of financial accounting however significant it is.

2. Recording of information:

   Accounting is an art of recording financial transactions of a business concern. There is a limitation for human memory. It is not possible to remember all transactions of the business. Therefore, the information is recorded in a set of books called Journal and other subsidiary books and it is useful for management in its decision making process.

3. Classification of Data:
The recorded data is arranged in a manner so as to group the transactions of similar nature at one place so that full information of these items may be collected under different heads. This is done in the book called „Ledger”. For example, we may have accounts called „Salaries”, „Rent”, „Interest”, Advertisement”, etc. To verify the arithmetical accuracy of such accounts, trial balance is prepared.

4. Making Summaries:

   The classified information of the trial balance is used to prepare profit and loss account and balance sheet in a manner useful to the users of accounting information. The final accounts are prepared to find out operational efficiency and financial strength of the business.

5. Analyzing:

   It is the process of establishing the relationship between the items of the profit and loss account and the balance sheet. The purpose is to identify the financial strength and weakness of the business. It also provides a basis for interpretation.

6. Interpreting the financial information:

   It is concerned with explaining the meaning and significance of the relationship established by the analysis. It should be useful to the users, so as to enable them to take correct decisions.

Communicating the results:

   The profitability and financial position of the business as interpreted above are communicated to the interested parties at regular intervals so as to assist them to make their own conclusions.

LIMITATIONS OF FINANCIAL ACCOUNTING:

Financial accounting is concerned with the preparation of final accounts. The business has become so complex that mere final accounts are not sufficient in meeting financial needs. Financial accounting is like a post-mortem report. At the most it can reveal what has happened so far, but it can not exercise any control over the past happenings.

The limitations of financial accounting are as follows:-

1. It records only quantitative information.

2. It records only the historical cost. The impact of future uncertainties has no place in financial accounting.

3. It does not take into account price level changes.
4. It provides information about the whole concern. Product-wise, process-wise, department-wise or information of any other line of activity cannot be obtained separately from the financial accounting.

5. Cost figures are not known in advance. Therefore, it is not possible to fix the price in advance. It does not provide information to increase or reduce the selling price.

6. As there is no technique for comparing the actual performance with that of the budgeted targets, it is not possible to evaluate performance of the business.

7. It does not tell about the optimum or otherwise of the quantum of profit made and does not provide the ways and means to increase the profits.

8. In case of loss, whether loss can be reduced or converted into profit by means of cost control and cost reduction? Financial accounting does not answer this question.

9. It does not reveal which departments are performing well? Which ones are incurring losses and how much is the loss in each case?

10. It does not provide the cost of products manufactured.

11. There is no means provided by financial accounting to reduce the wastage.

12. Can the expenses be reduced which results in the reduction of product cost and if so, to what extent and how? No answer to these questions.

13. It is not helpful to the management in taking strategic decisions like replacement of assets, introduction of new products, discontinuation of an existing line, expansion of capacity, etc.

14. It provides ample scope for manipulation like overvaluation or undervaluation. This possibility of manipulation reduces the reliability.

15. It is technical in nature. A person not conversant with accounting has little utility of the financial accounts.

**COST ACCOUNTING:**

An accounting system is to make available necessary and accurate information for all those who are interested in the welfare of the organization. The requirements of majority of them are satisfied by means of financial accounting. However, the management requires far more detailed information than what the conventional financial accounting can offer. The focus of the management lies not in the past but on the future. For a businessman who manufactures goods or renders services, cost accounting is a useful tool.
It was developed on account of limitations of financial accounting and is the extension of financial accounting.

The advent of factory system gave an impetus to the development of cost accounting. It is a method of accounting for cost.

The process of recording and accounting for all the elements of cost is called **cost accounting**.

The Institute of Cost and Works Accountants, London defines costing as, “the process of accounting for cost from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centers and cost units.

In its wider usage it embraces the preparation of statistical data, the application of cost control methods and the ascertainment of the profitability of activities carried out or planned”.

The Institute of Cost and Works Accountants, India defines cost accounting as, “the technique and process of ascertainment of costs.

Cost accounting is the process of accounting for costs, which begins with recording of expenses or the bases on which they are calculated and ends with preparation of statistical data”.

To put it simply, when the accounting process is applied for the elements of costs (i.e., Materials, Labor and Other expenses), it becomes Cost Accounting.

**OBJECTIVES OF COST ACCOUNTING:**

Cost accounting was born to fulfill the needs of manufacturing companies. It is a mechanism of accounting through which costs of goods or services are ascertained and controlled for different purposes. It helps to ascertain the true cost of every operation, through a close watch, say, cost analysis and allocation.

The main objectives of cost accounting are as follows:

1. Cost Ascertainment
2. Cost Control
3. Cost Reduction
4. Fixation of Selling Price
5. Providing information for framing business policy.

**1. Cost Ascertainment:**

The main objective of cost accounting is to find out the cost of product, process, job, contract, service or any unit of production. It is done through various methods and techniques.
2. Cost Control:

The very basic function of cost accounting is to control costs. Comparison of actual cost with standards reveals the discrepancies (Variances). The variances reveal whether cost is within control or not. Remedial actions are suggested to control the costs which are not within control.

3. Cost Reduction:

Cost reduction refers to the real and permanent reduction in the unit cost of goods manufactured or services rendered without affecting the use intended. It can be done with the help of techniques called budgetary control, standard costing, material control, labor control and overheads control.

4. Fixation of Selling Price:

The price of any product consists of total cost and the margin required. Cost data are useful in the determination of selling price or quotations. It provides detailed information regarding various components of cost. It also provides information in terms of fixed cost and variable costs, so that the extent of price reduction can be decided.

5. Framing business policy:

Cost accounting helps management in formulating business policy and decision making. Break even analysis, cost volume profit relationships, differential costing, etc are helpful in taking decisions regarding key areas of the business like

a. Continuation or discontinuation of production
b. Utilization of capacity
c. The most profitable sales mix
d. Key factor
e. Export decision
f. Make or buy
g. Activity planning, etc.

NATURE AND SCOPE OF COST ACCOUNTING:

Cost accounting is concerned with ascertainment and control of costs. The information provided by cost accounting to the management is helpful for cost control and cost reduction through functions of planning, decision making and control. Initially, cost accounting confined itself to cost ascertainment and presentation of the same mainly to find out product cost. With the introduction of large scale production, the scope of cost accounting was widened and providing information for cost control and cost reduction has assumed equal significance along with finding out cost of production.
To start with cost accounting was applied in manufacturing activities but now it is applied in service organizations, government organizations, local authorities, agricultural farms, extractive industries and so on.


It helps management to eliminate the unprofitable activities.

It provides information for estimate and tenders.

It discloses the losses occurring in the form of idle time spoilage or scrap etc.

It also provides a perpetual inventory system.

It helps to make effective control over inventory and for preparation of interim financial statements.

It helps in controlling the cost of production with the help of budgetary control and standard costing. Cost accounting provides data for future production policies.

It discloses the relative efficiencies of different workers and for fixation of wages to workers.

**LIMITATIONS OF COST ACCOUNTING:**

1. **It is based on estimation:** as cost accounting relies heavily on predetermined data, it is not reliable.

2. **No uniform procedure in cost accounting:** as there is no uniform procedure, with the same information different results may be arrived by different cost accounts.

3. **Large number of conventions and estimate:** There are number of conventions and estimates in preparing cost records such as materials are issued on an average (or) standard price, overheads are charged on percentage basis, Therefore, the profits arrived from the cost records are not true.

4. **Formalities are more:** Many formalities are to be observed to obtain the benefit of cost accounting. Therefore, it is not applicable to small and medium firms.

5. **Expensive:** Cost accounting is expensive and requires reconciliation with financial records.

6. **It is unnecessary:** Cost accounting is of recent origin and an enterprise can survive even without cost accounting.
7. **Secondary data:** Cost accounting depends on financial statements for a lot of information. Any errors or short comings in that information creep into cost accounts also.

**MANAGEMENT ACCOUNTING:**

- Management accounting is not a specific system of accounting.

- It could be any form of accounting which enables a business to be conducted more effectively and efficiently.

- It is largely concerned with providing economic information to managers for achieving organizational goals.

- It is an extension of the horizon of cost accounting towards newer areas of management.

- Much management accounting information is financial in nature but has been organized in a manner relating directly to the decision on hand.

- 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.

Management accounting is of recent origin. This was first used in 1950 by a team of accountants visiting U. S. A under the auspices of Anglo-American Council on Productivity Definition: 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 follows: “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.

**OBJECTIVES OF MANAGEMENT ACCOUNTING:**

The fundamental objective of management accounting is to enable the management to maximize profits or minimize losses. The evolution of management accounting has given a new approach to the function of accounting.

The main objectives of management accounting are as follows:

1. **Planning and policy formulation:**
   - Planning involves forecasting on the basis of available information, setting goals; framing polices 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.

2. **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.

3. **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.

4. **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 affected 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.

5. 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.

6. 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.

7. Facilitates Coordination of Operations:

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

**NATURE AND SCOPE 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 nature of management accounting.

1. 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.

2. **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.

3. **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.

4. **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.

5. **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.

6. 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.

7. 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.

8. 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.

9. 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:

1. 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.

2. 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.

3. 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.

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