Managerial Accounting
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Module - 1
Lecture - 1
Introduction to Management Accounting

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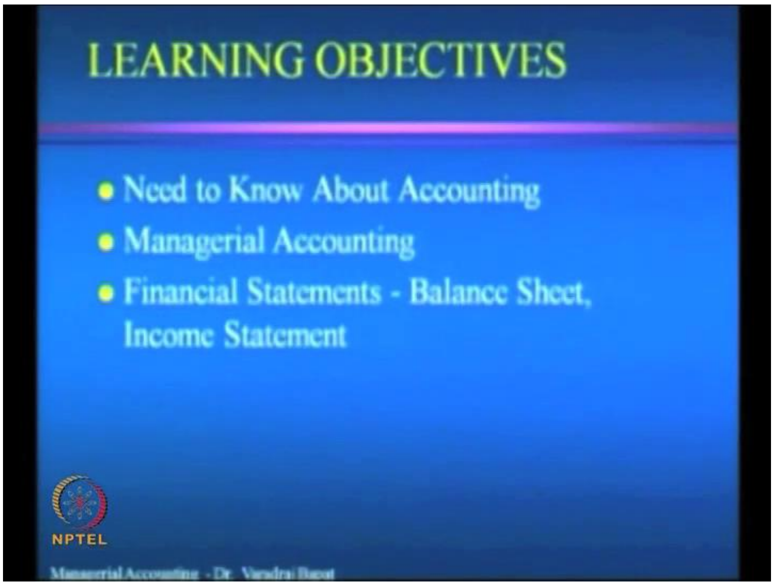

Welcome everyone to the course on Managerial Accounting. Today, we are going to discuss about what do you understand by Managerial Accounting? What is the need to know about accounting; and little bit will go into details of financial statements.

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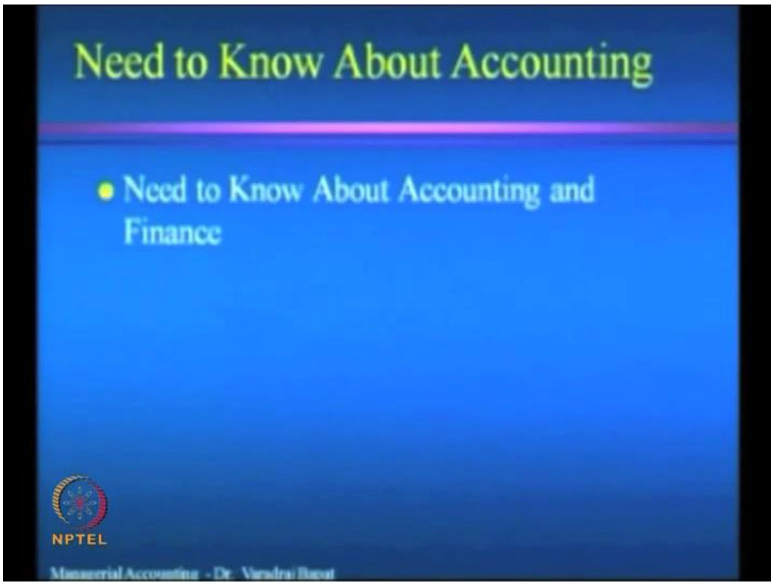

First question, which may come to the minds of those, who are not accountants is; is it necessary for them to understand to know what is accounting and finance?

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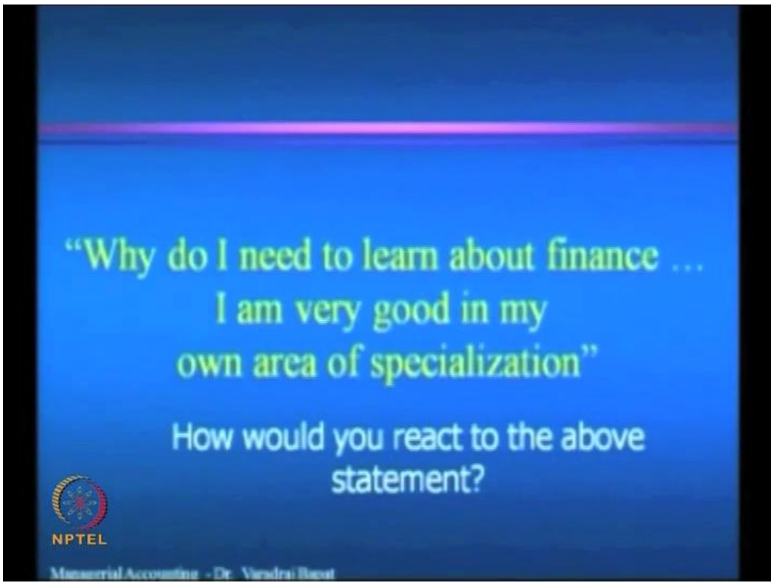

You can see this question that I have a person; I am engineer, or I am a doctor. I am a person from a non-finance background. What is the need to know the accounting?

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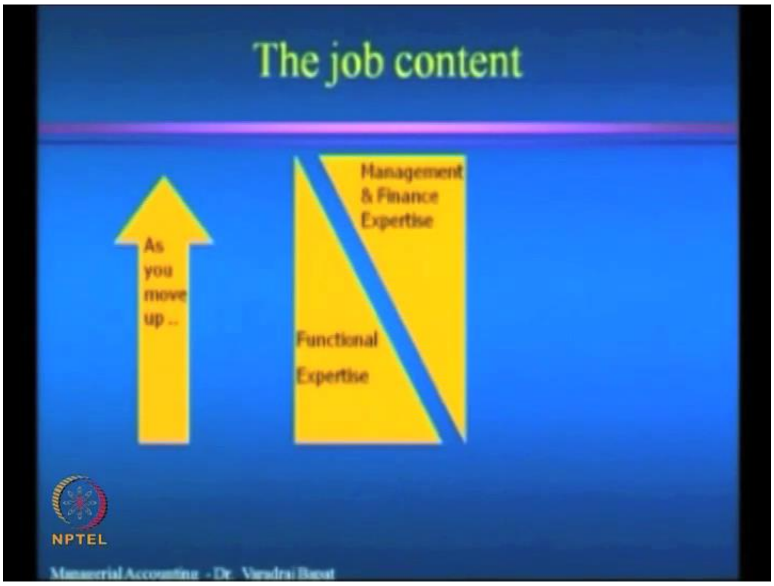

As you all know, as you move up the ladder in your organization, the need for your specialist knowledge will go down. What you will need is more and more knowledge about management and more information about finance. Your job content will be more towards knowing what other people are doing; evaluating their performance; setting the goals in financial terms; looking at what is organization doing. So, it will be necessary to know the financial terms. It will be necessary to understand the financial statements. It will also be necessary to evaluate the performance of your subordinates in financial terms. That is why the knowledge of accounting and finance, will become more and more important, irrespective of what specialization you are from.

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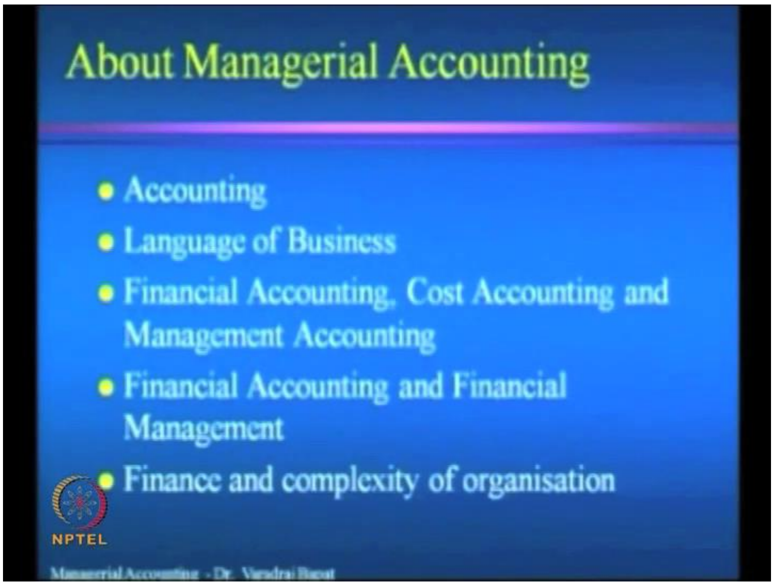

What we are going to cover today, in managerial accounting is (a) will know what is accounting. Then, will try to understand the difference between financial accounting, cost accounting and management accounting. We will look at the similarities and differences between financial accounting and financial management, and then will see how complexity of business affects the finance function as a whole.

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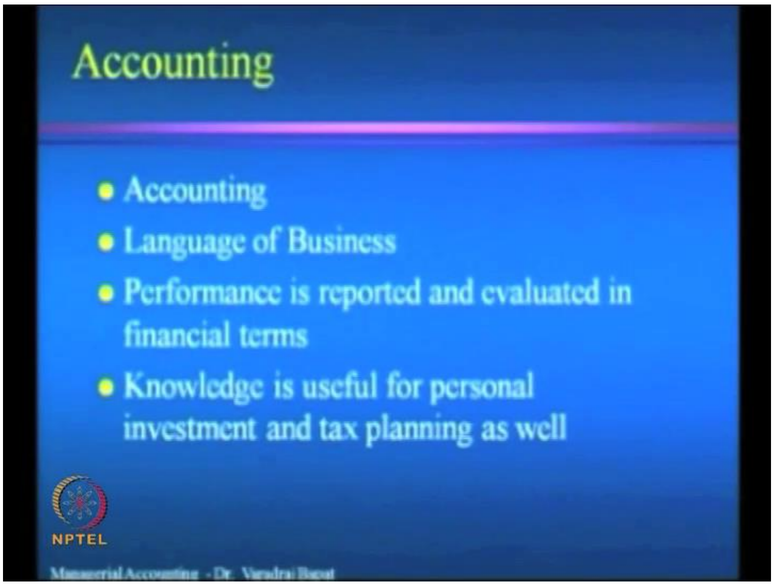

The first part; we will think about accounting. What is accounting? Accounting, in very simple terms, is language of business. The intention of accounting is to record the transactions and to present the financial results. So, the performance is reported and evaluated in financial terms. The knowledge of accounting and finance is also very important for personal investment and tax planning.

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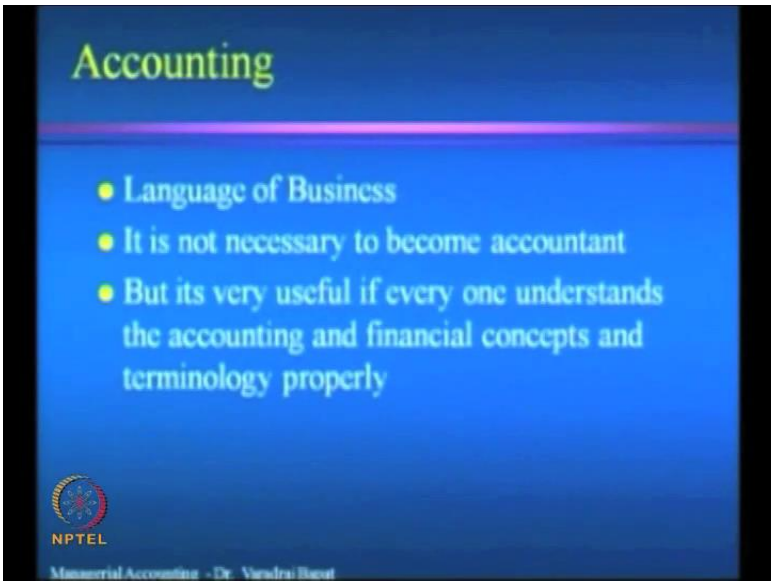

Now, the purpose of this course is not to make you an accountant. So, you need not be an accountant, but it is very useful for one, to understand accounting and financial concepts and the terminologies.

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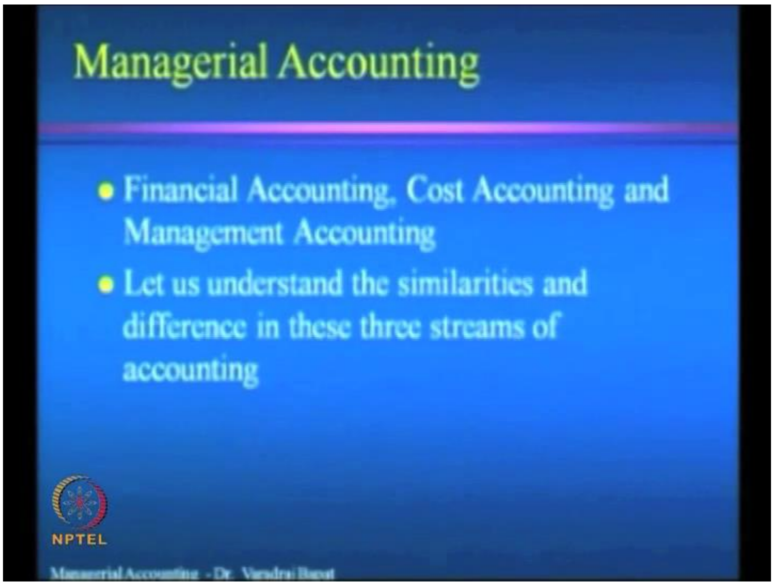

Now, we will go to managerial accounting, where in, as we have said, we are going to see the similarities and differences between financial accounting, cost accounting and management accounting. These are the three streams of accounting, which have a good number of similar points, but there are a few differences also. It will be good for us to start with that. The first one is financial accounting.

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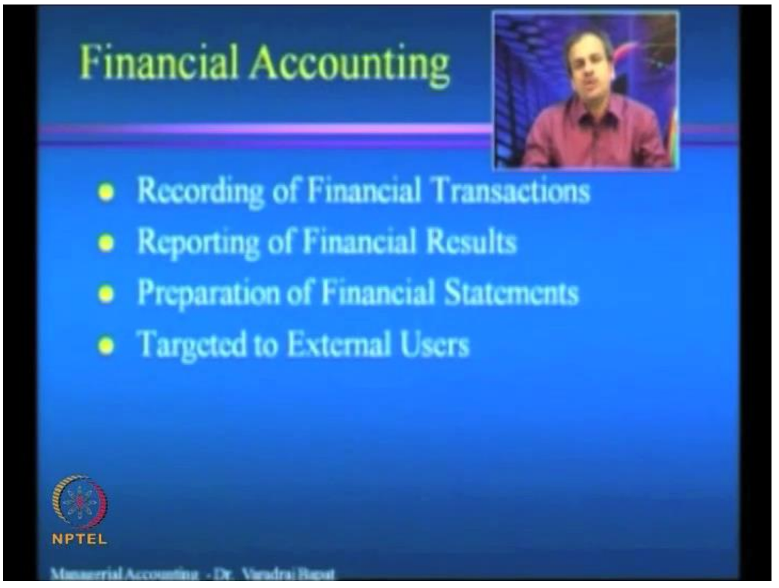

Now, the financial accounting starts with the recording of financial transactions. Once, the financial transactions are recorded, the second job of financial accounting is to prepare financial statements, which will lead to reporting of financial results. The targeted users are mainly external users. There are a variety of stakeholders; they could include owners; they could include lenders; they could include employees; they could include government; they could include regulator; all the stakeholders demand that financial statements are prepared properly, and a financial results of any organization is presented in an objective and fair manner. That is the main role of financial accounting function.

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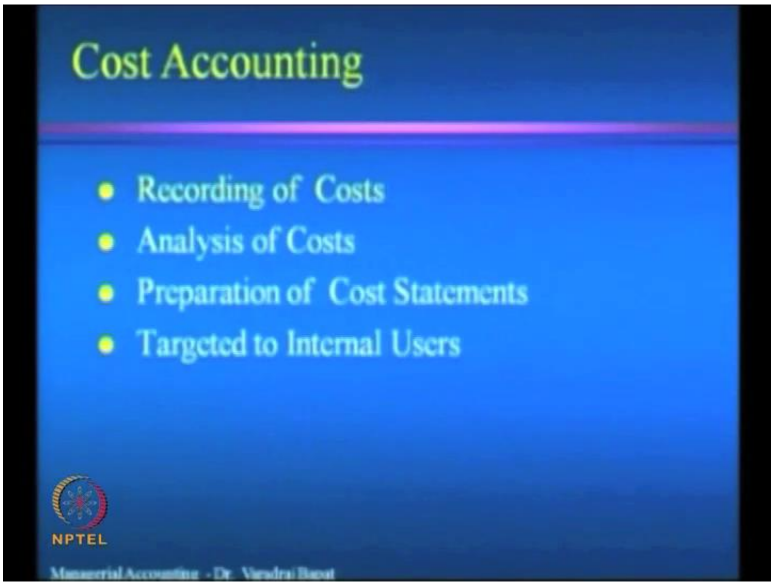

Second is cost accounting. In cost accounting, there are four activities. First is naturally, to record the cost. The second one is the analysis of the cost. The third is preparation of cost statements. The target of cost accounting is mainly, internal users. Now, I have given the first function; the recording of cost slightly in a different color, because recording of cost mainly, is covered by recording of financial transactions. As such, there is no need to record the cost again. It will lead to a duplication of work. So, recording of cost need not be duplicated.

The second activity is analysis of the cost, and that is very important, because financial accounting may give you the ultimate financial results, but it may not give you the detailed breakup of cost. When we prepare cost accounting records or cost accounting reports, the intension is to know product wise cost. It may be function wise cost. It may be machine wise cost. One would like to know a variety of detailed cost for salary; detailed cost for raw material; detailed cost for transportation; so function wise details of the cost. All these details will be provided from cost accounting records and the statements are prepared by cost accountants, which give a table of costs analyzed and presented in the variety of ways. The target users are internal users; they could be managers; they could be those, who are in-charge of controlling and regulating the cost; or they could be decision makers, who would like to look at other alternatives, for a particular activity. Now, we will go to the third that is management accounting.

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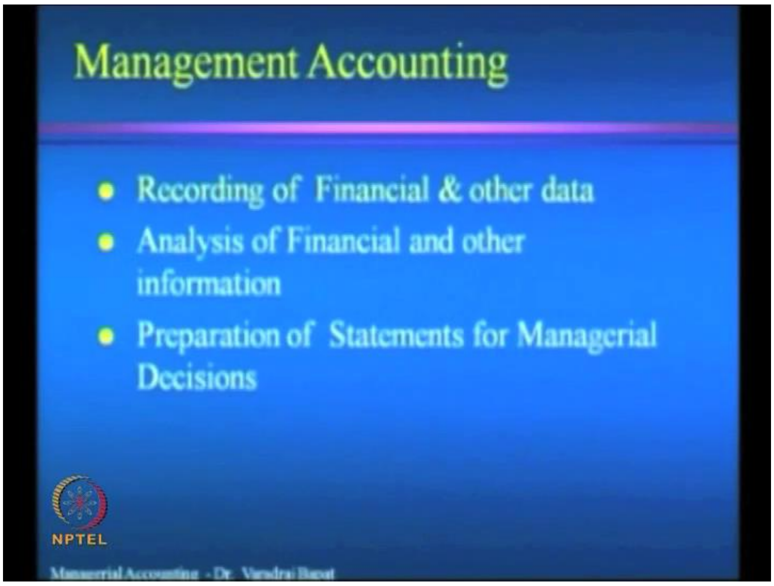

In management accounting, again, the first step is recording of financial and other data. I have again; put it in a different color, because this is already covered in financial accounting. Perhaps, the data may be already available. The detailed financial and cost data is available, when you go for management accounting. The second part is very important; that is analysis of financial and other information, and preparation of statements for managerial decision making. Now, managerial decision making is a very vast term. The decisions could be tactical ones; that is short term ones. They could relate to the choice of raw material. They could relate to the choice of transportation options. They could be long term, like setting up a new plant and machinery, or starting up a new venture; taking over a company. Now, for taking any short term or long term decision, a variety of information is needed. It is the role of management accountant to make available the required information by the level of management, which has requested for that information.

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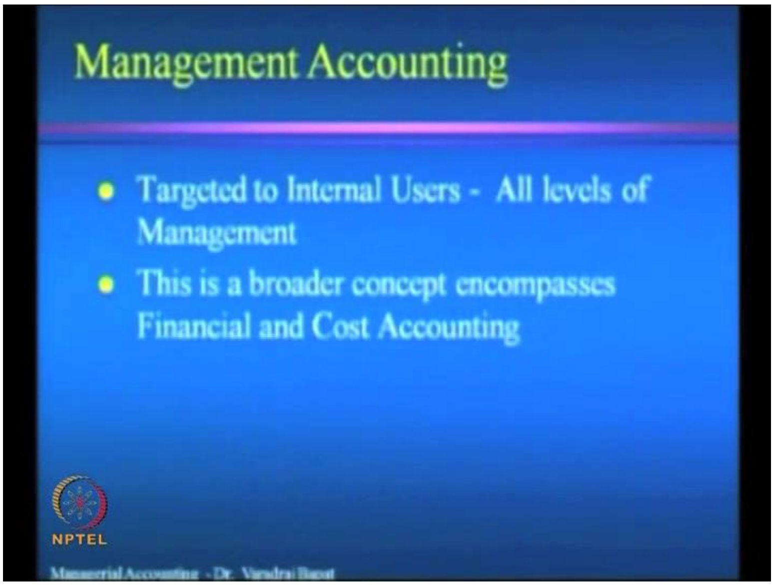

Now, here, as we have seen that targeted users are internal users, and they are a variety of levels of management, right form a very basic supervisory level; it could be middle management; it could be top management; it may be CEO; it may be board of directors. All the levels of management continuously, need customized information, and management accounting tries to provide the required information. It is to be made available at right time; it should be concised; it should be accurate. All this will become the responsibility of the management accounting. That is why management accounting is usually, considered as a broader concept. It includes or encompasses financial as well as cost accounting. When we talk of financial accounting, our concentration is more on recording the cost, and reporting to the external users. When we talk of cost accounting, we collect financial data, and we also collect detailed cost data. The data is analyzed and it is presented cost wise. When we talk of management accounting, it compasses both these functions. So, we have financial data, and we also have cost data. The entire data is analyzed in a systematic manner and then it is presented to the right level of management.

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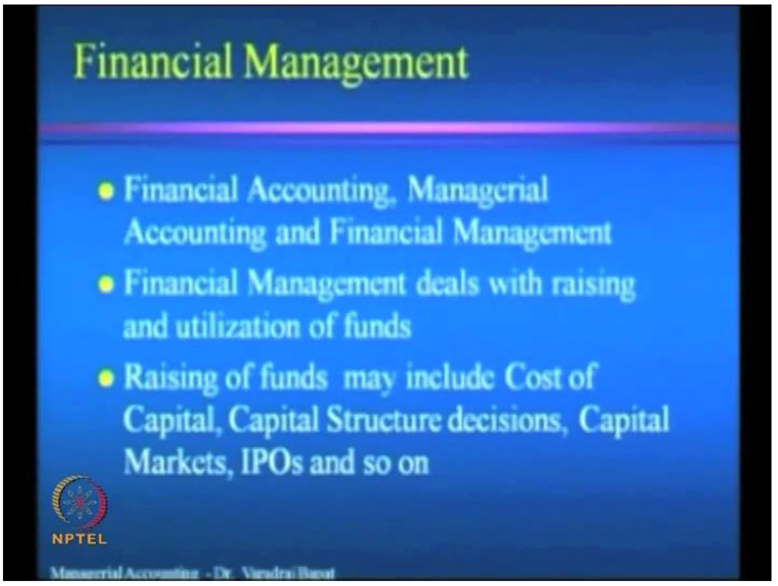

I hope, the difference between these three terminologies is clear to you. Now, we will go to financial management. Many times, the term financial accounting, management accounting and financial management are used, sort of, as an alternative to each other, as if they carry the same meaning. We will try to understand the similarities and differences between these two. Now, the financial management mainly, looks at the raising and utilization of funds. For any organization, to run its activities, it requires finances; it requires funds or capital. So, the first job is making the capital available. The capital will be made available by raising resources. The sources could be through capital market; it could be through loans; it could be going for an IPO. One needs to analyze the cost of capital. One needs to take the decision about capital structure. By capital structure, I mean the owners and the board has to decide what should be the component of loans; what should be the components of owners' funds. Once these decisions are taken, the actions have to be taken for making the funds available. All this is generally, covered in the function of raising of finance.

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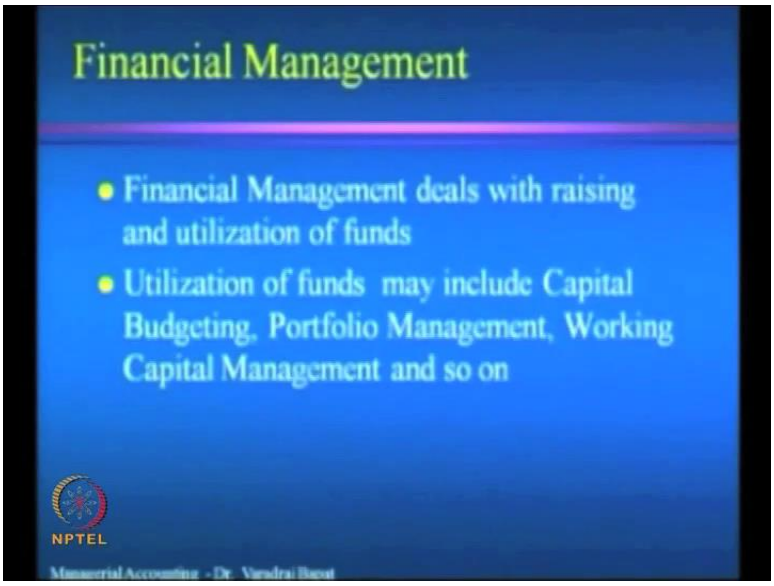

The second part of financial management deals with utilization of the funds. Now, that the funds are available, they could be used for a short term use, or they could be used for a long term use. Generally, the utilization for the short term use is for capital budgeting. So, here, the varieties of projects are taken into account. Then, those projects are evaluated. A suitable project or a set of projects are identified. One may also look at the working capital management; working capital management mainly, concentrates on short term utilization of money. It will cover inventory management. It will cover the management of receivables. It will cover cash management. There is also an aspect of effective utilization of surplus funds. It may be in the form of portfolio management. So, one has to look at where, to put this funds; what return can come; will they provide the required liquidity; is the risk being properly managed; all these things are primarily, covered in the function of utilization of funds.

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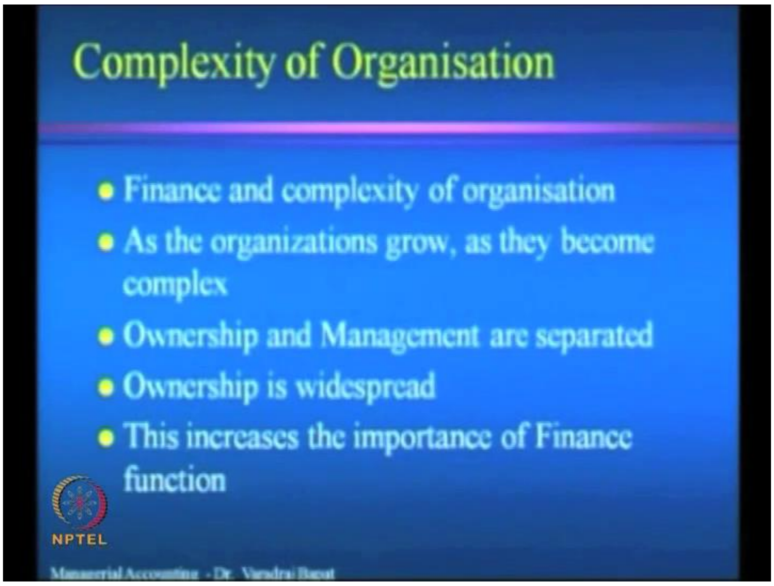

As we have seen, the financial management slightly, goes beyond a course or the beyond space provided by this course. So, we will be concentrating mainly, on managerial accounting, and we will not go much into the details of financial management. Now, we will look at one more aspect; that is complexity of organization. As we have seen, the finance function encompasses a variety of things. The need for detailed financial function, increases with the growth of business, because as the size of business grows the business becomes complex; there are more and more stakeholders. Usually, the ownership and management becomes separated. For example, let us say you start with a very small business. The owner himself provides the capital. The owner himself becomes manager. So, we have same person giving capital, same person managing. Loans may be very small, or loans may be coming from relatives or close friends as such, there is no diffusion of ownership and management, whereas the business grows, it may become a partnership firm. So, there will be a number of owners. One may go for a loan from bank. As the size further grows, business may convert itself into a company.

So, we will have a number of owners in the form of shareholders. Other stakeholders like banks, lenders will also increase. Suppliers or customers may also diffuse. There may be stakeholders in the form of regulators or the government. So, as the complexity of the business increases, it becomes very important that the business transactions are recorded in a systematic manner. The results of the business are reported in objective manner. It is also necessary then; to look at how is the management of finances; is the business earning a good return for the owners; is the risk properly, evaluated; is the risk properly, managed. So, as the complexity of the business increases, it becomes more and more necessary to concentrate on the finance function.

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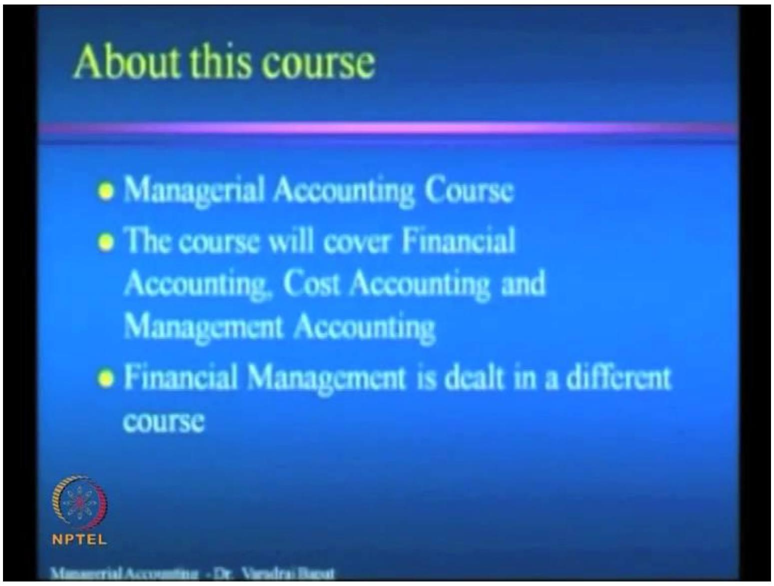

Now, we will go, will talk a little bit about what is going to be the coverage of the course. We are going to cover the three streams of accounting which, we have just discussed in detail; that is financial accounting, cost accounting and management accounting. Financial management will be dealt with in a separate course, so we will not deal in detail in this course.

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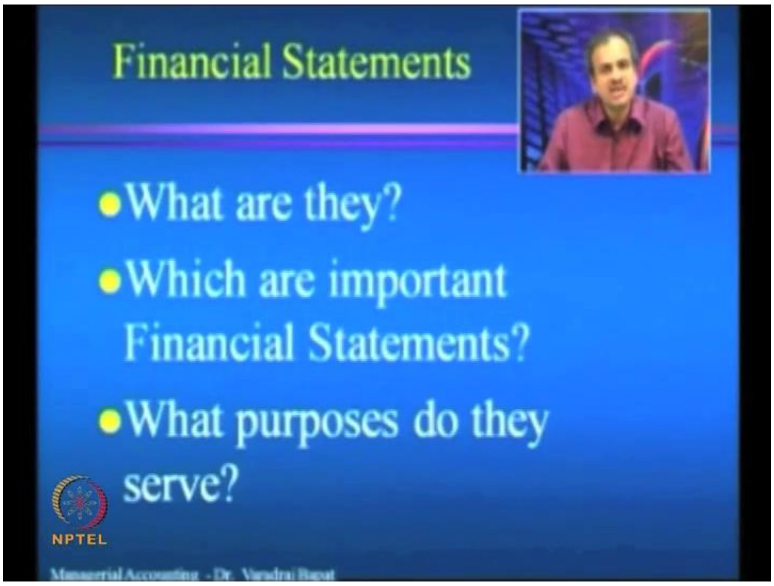

Now, let us go to the second part of today's session that deals with the financial statements. Whenever, we talk about financial accounting or reporting, the final outcome is in the form of financial statements. So, it is very necessary for us to know; what is a financial statement; what are the important statements, and what is the purpose that these statements serve. Now, financial statement is a very wide term. A variety of statements which will give financial data, are termed in short, as financial statements, but the important financial statements as publicly reported are profit and loss account, balance sheet, and cash flow statement. If you look at the annual report of any of the companies, which are listed with the stock markets, you can see minimum of these three statements, made available to the entire public. Apart from these, there could be a number of statements for the internal users; they could be cost estimates; they could be budgets; they could be financial report for a particular division. Now, each of the financial statements actually, serves a variety of purposes.

They are prepared with a different focus in mind. In short we can say that balance sheet is intended to be a statement prepared at the end of a period, to show the financial position of the concern. Profit and loss account talks about the profitability; about how effectively, the business is run in a particular year or in a quarter. Cash flow statement talks about how is cash coming in, and going out; we are going to discuss in detail about these statements.

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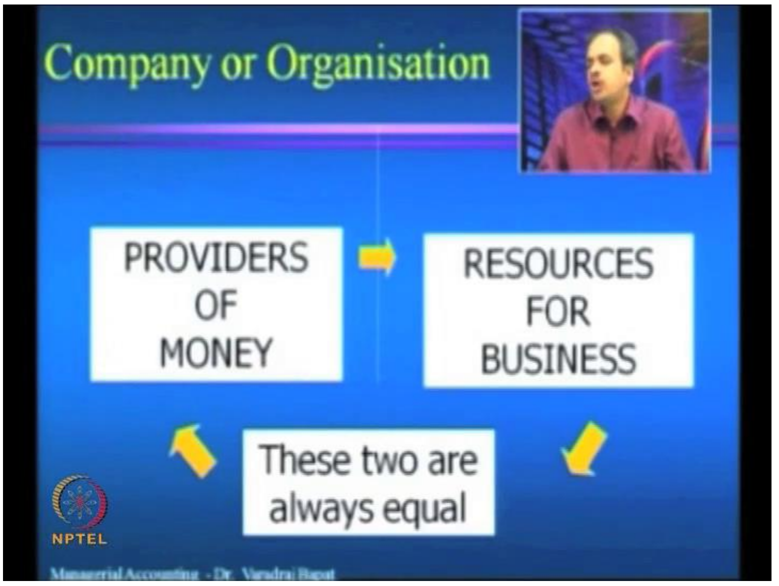

Let us go one by one. Before going into financial statement, let us understand how a company or a particular business goes or runs. For running the business, one naturally, requires resources. Resources cannot come for free; they have to come from providers of funds or providers of money. That is why at any point of time, both of these should match. Resources should be equal to the providers of the money.

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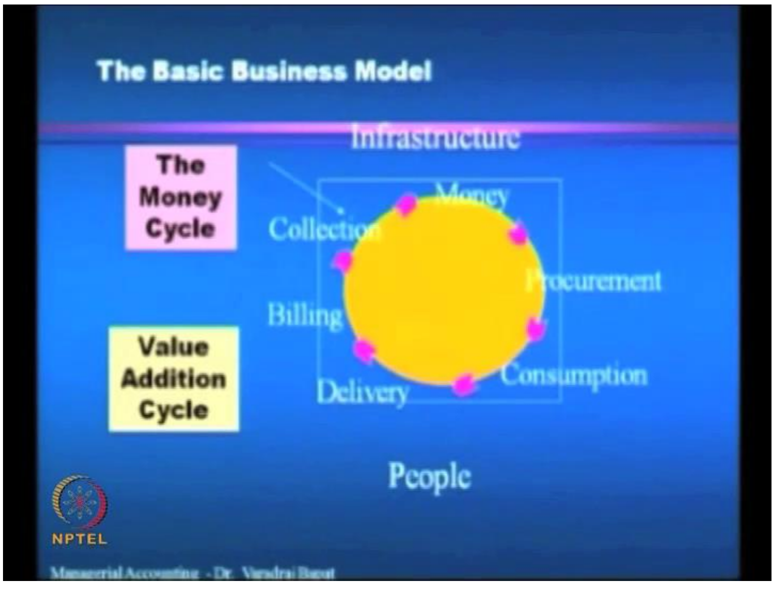

Now, we are looking at the basic business model. You can see here, this is a cycle, which starts with money. Usually, it follows by the procurement of raw material. There is consumption in the process of manufacturing of raw material or completion of work. We get the finished goods as output. Then, there is a delivery; there is billing; there is collection; and once, the collection is over, the money is received back. In nutshell, this can be considered as money cycle. Now, these two things; infrastructure and people; they are required to support the running of money cycle. The money cycle is also known as value addition cycle; because the money you get at the end of the cycle, should be more than the money which you have put in.

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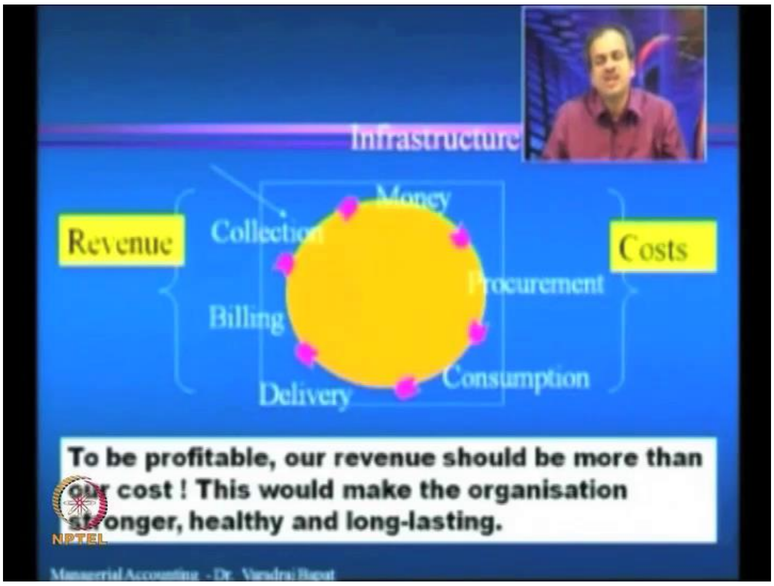

Now, here, the same cycle is repeated. You can see that at the stage of procurement or consumption, the costs are incurred. While from the point of delivery, billing and collection, we get revenues. To be profitable, revenue should be more than the cost. If there is a sufficient revenue generation or revenue creation, the business becomes stronger, healthy and long lasting. Why it become stronger, because more profitability will give the capacity to expand the activities. So, the health of the business will improve. Better quality employees will join. This will also help the business to last for the longer period, because it will have the capacity to bear recession; it will have the capacity to bear the bad times; it will generate internal resources to support the expansion. So, the generation of surplus or addition of the value becomes key to the success of the business.

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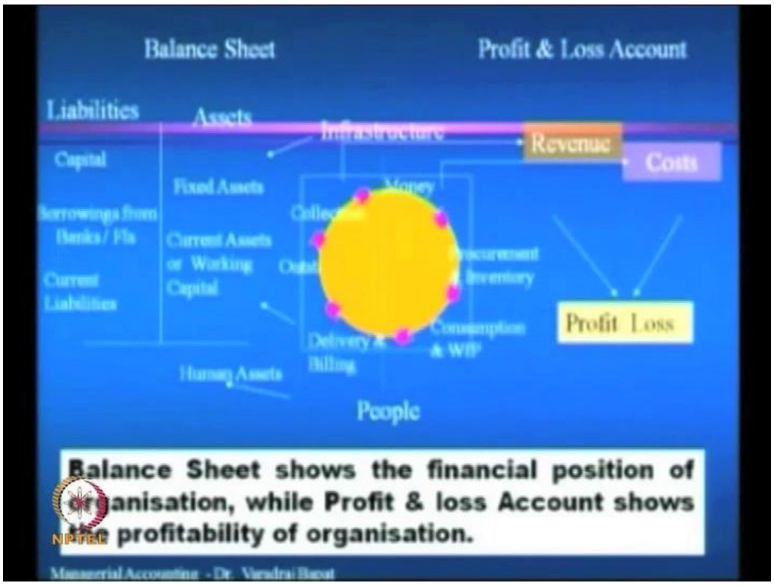

Now, let us look at how are the financial statements, evolved from the basic money cycle. You can see here, that we have costs and revenues, coming from the money cycle. They are compared to calculate the profit or loss. On the other side, you can see balance sheet. The infrastructure, which is required for the money cycle, but which itself, does not take part in money cycle; is represented in the form of assets. The assets, which come from money cycle, are called as working capital or current assets. You can see human assets as well, but human assets do not form part of the balance sheet though, they are very valuable to the business; they are not owned by the company. That is why it is shown in, but it is shown below the balance sheet. As we have discussed before, the resources for the business, have to come from some providers. Resources are nothing, but your assets. The providers of business are called as liabilities. You can see here, there are capital borrowings and current liabilities, which are all considered as providers of business. Now, you can see here, balance sheet, which shows the financial position of the organization. We have profit and loss account, which shows the profitability of the organization.

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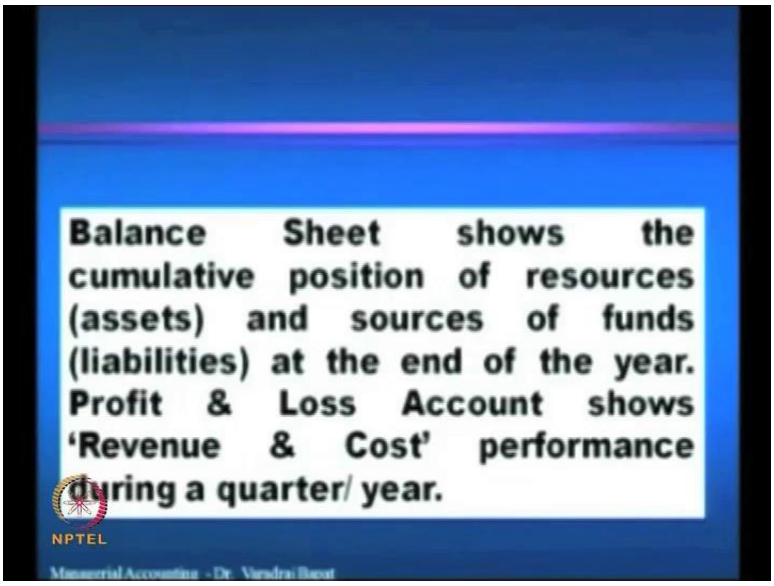

Now, the balance sheet is considered as a cumulative position of resources, or the assets, and the sources of the business, which are known as liabilities, that is, at the end of the year. Whereas, profit and loss account shows the revenue and cost performance during a particular year. I would like you to carefully, read these statements. There is a slight difference, because when it comes to balance sheet, we have said it is a cumulative position; whereas, when it comes to profit and loss account, we have said it is a performance during a particular period. There is a difference in it. For example, let us say if you have purchased land, 10 years before, and the land is not yet sold. It will be continued to be shown in the balance sheet of the business, but if you have generated some sales 10 years before, or say in the last year; that cannot be shown in the profit and loss account for this year. So, profit and loss account will show the revenue and cost only, in the last year. Whereas, the balance sheet will show cumulative financial position, right from the inception or the starting of the business, to the date on which the balance sheet is prepared.

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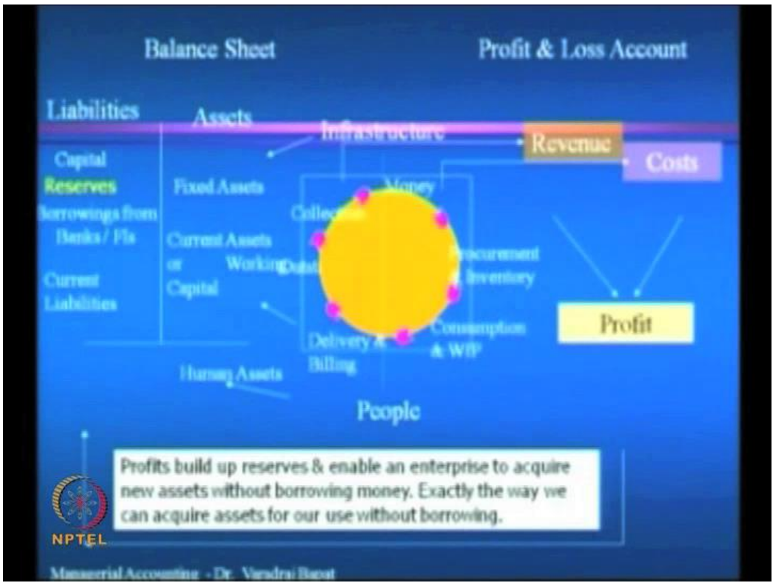

Let us go back to the money cycle. Here, you have already seen up to this point of time, that revenue and cost; the difference in profits; the assets and liabilities are shown in the balance sheet. So, one can very well understand that at the starting of the business, on day one, the assets will match the liabilities. The question is, as the business roles on, as the money cycle roles on; the business will generate surpluses. The impact will be; the assets will be added, and the liabilities will not be added. Perhaps, the liabilities may go down, because loans will be repaid and business will have more money. Now, how will the balance sheet match? So, you can take a look at the money cycle. You can see here, that as the business grows; it generates reserves. Now, reserves are nothing, but accumulated profits. The surpluses or the profits, which are coming from profit and loss account, are built into reserves in the balance sheet; that shows really, the health of the business.

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Now, here, you can see that the reserves are getting built up. Now, this is a balance sheet in nutshell. We have three major headings under assets; that is fixed assets, there are current assets and investments. You can also see under the liability side, we have got owners funds; we have long term liabilities and we have got current liabilities. Let us understand these terms, once again. On asset side, we have fixed assets. The meaning of the term fixed asset is, the infrastructure. These are the assets, which do not take part in money cycle, but they are important, in a sense that they ensure that money cycle runs properly. They are, sort of, catalyst, which assist in the money cycle. I hope you all know the examples of fixed assets. They could be in the form of say, land; it could be the vehicles; it could be equipments; it could be software; it could be hardware. So, all those, which themselves are not getting converted, but which are necessary for running of the business, which are necessary to support the business; they are called as fixed assets. Now, let us look at the second heading.

Next to fixed assets, we have got current assets. As we have already seen, these are the assets, which emerge from money cycle. So, as the business roles on, we have to buy raw materials. Those raw materials stocks are the examples of fixed assets. Then, when one does billing, customers will not pay immediately. So, there will be debtors, or accounts receivables. You will have some surplus cash in hand. All these are considered as examples of current assets. You may have put in advances with some customers, or you may have put in some advance with some say, electricity supply authorities. All these will be considered as current assets. The third heading under the head assets is new to you. That is investment; it is new to you, because it was not from the money cycle.

You can have a look again. You can see here, there is no mention of investments, but look at the next slide; investments are included. The reason why now, the investments are shown, because investments are not coming from money cycle; they represent the surplus cash, which is invested outside a business. It is worthwhile to understand the concept of investment properly, because the term investment is used in a variety of way by different people. Suppose, you invest some money in purchasing say, car; should it be considered as an investment? If you invest some money in constructing a road; is it an investment? If you say, a company invests some money in providing training or education to the employees; is it an investment?

In broad sense, yes, because all these will require some cash out go; it will require some money to be spent. However, when we talk of investment, in the sense of accounting and finance, the term is very narrowly defined. So, if I have purchased a car, it will be considered as a fixed asset, and it cannot be treated as an investment. Let us say I spend money on education. It will be considered as the expenditure. Again, it cannot be considered as an investment. So, when I use the term investment here, what I mean is this is extra cash; this is surplus cash, which is invested or which is put in, outside the business.

So, we have got three main categories under the assets. There is a fixed asset; then there is current assets and investment. Now, let us look at the other side. The other side is liabilities. You can see here liabilities as three headings; owners' funds; then there is long-term liabilities and current liabilities. Now, a natural question is; what do you mean by owners' funds. Now, owners' funds are the money, which are owned by the proprietors or the owners. So, this in turn, has two parts; one is the capital, which is the money actually, invested; the other part is the reserves or the profits, which are generated by the business, but they very much belong to the owners. So, the total of capital plus reserves; it shown as or is considered as owners' funds. The second heading is long-term liabilities. By long-term liabilities, we mean a variety of loans; the loans could be from banks; it could be from friends or relatives; it could be by way of raising money by debentures; all this money is considered as a long-term liabilities. The third heading is current liabilities. Current liabilities are mainly, the liabilities, which emerge from money cycle. You can have a view of the earlier slide, once again. You can see here, form the money cycle, I have shown an arrow, which says that current assets or working capital is emerging from money cycle. Now, this working capital includes current assets as well as current liabilities. So, these current liabilities are the short-term funds, which are continuously changing hands. I will give you an example. So, the example could be outstanding salaries; it could be the amounts, which are payable to the suppliers of goods; it could also be some telephone bills or electricity bills, which are pending; all these taken together, are considered as current liabilities.

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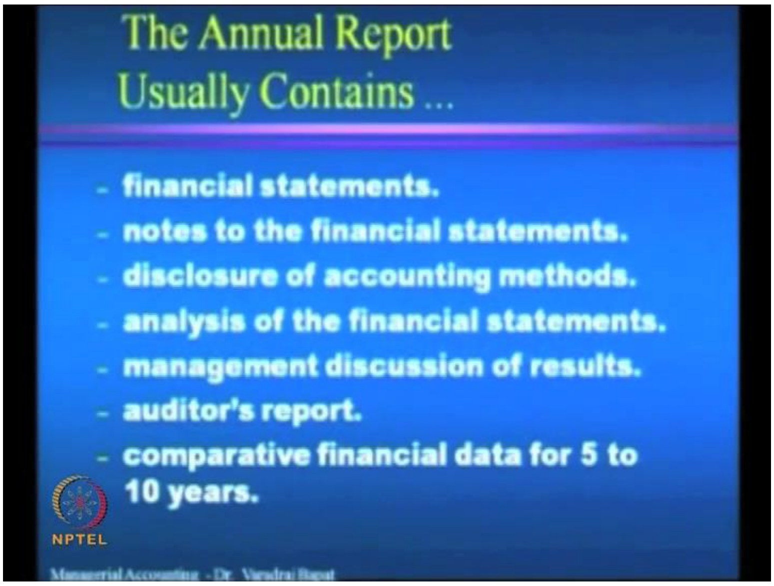

Let us go to the next slide, now. Now, here, we are discussing about a variety of financial statements. These financial statements; the best source for you to get these statements is in the form of annual report. Now, an annual report will usually, contain financial statement, but apart from financial statement, you will see; notes to accounts. You can see disclosure of accounting methods, analysis of financial statements. There will be management discussion of results. There will be auditor's report, and there will be a comparative financial data for last 5 to10 years. My advice to everybody is you have to look at the annual report of two or three companies. The annual reports are freely downloadable on internet, or if you know any shareholder of a particular company, the shareholders also get the annual reports in physical format. So, I will advice each one of you, to take a look at an annual report. So, that you really understand how the financial statements are. You can also see the notes to financial statements, which tell you some procedure about how a financial statement is prepared. It will also discuss about the financial performance of the company during last three to four years. The annual report will serve the purpose of basic; it will give you some idea about how the financial statements work, and how they are used.

Thank you.