UNIT 11 FLOW OF FUNDS IN THE ECONOMY

Structure

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11.0 OBJECTIVES

After going through this unit, you will be able to:

- explain the origin and definition of flow-of-funds accounting system and its relationship with other accounting systems;
- describe the construction and presentation of flow-of-funds system;
- discuss the usefulness and application of flow of funds;
- describe the flow-of-funds Practice in India; and
- state the limitations of flow-of-funds.

11.1 INTRODUCTION

In an economic system, one finds two-way relationship between goods and services and, the money in circulation. Flow of credit and money affects all the goods and services produced. The latter are known as real activities. All those activities in turn affect the flow of credit and money. Real flows are reflected in the system of national accounts. These accounts take into account the measurement of values created in current productive activity in different sectors and their distribution among the factors of production in addition of giving a break-up of final expenditure between consumption, capital formation and exports.

There is no doubt that National Income Accounts is the most frequently used and discussed method of accounting system. These accounts seek to present the essential facts about nation's economic activity in a schematic manner. Just as Company's accounts relate to its business activity, national accounts relate to different economic activities of a nation. In addition of national accounts, there are three more equally important accounting systems. These systems are: (1) National Balance Sheet; (2) Input-Output analysis; and (3) Flow of funds accounts.

National Income accounts as stated above measure the output, income, expenditure, saving and investment of the economy for a given period of time, normally a year. The Balance of Payment accounts present the transactions of the domestic economy with the rest of the world. In fact, they are also a part of the national income accounts. The National Balance Sheet presents the various assets and liabilities of the economy at sector and national levels for a particular day of the year. That means, it gives the stock position of assets held and the liabilities created to acquire the assets. The input-output analysis depicts the inter-industry transactions during a year. They, thus, indicate the technological relationship between the inputs and outputs of various industries/ commodities.

These accounts, however, do not give full information, as financial flows remain ignored in these accounts. There is thus a need to have a complementary system that could explain the manner in which all the real and financial flows could be represented simultaneously.

The flow of funds system of accounts as a tool of general economic analysis is relatively of recent origin. This system was originally known as "Moneyflows accounting". The Flow of Funds Accounts represents a set of accounts designed to show transactions between different economic units effected through medium of money and credit. Each sector identifies and measures its sources and uses of funds. These accounts help in finding out the various channels through which funds flow to finance and act as a support to the real economic activity. The detailed definition of such an accounting system is given in the following section.

11.2 CONCEPT OF FLOWS OF FUNDS

The flow of funds is a system of social accounting that gives a statement of the "sources-and-uses-of-funds" of the each sector in which the economy is divided. This statement may also be called as the flow-of-funds matrix for the economy as a whole.

These accounts are prepared by dividing the economy into institutionally homogeneous groups, called sectors. For each sector, these accounts show the various transactions effected through the medium of credit and money. Each sector account identifies and measures the main sources and uses of funds. Thus, these accounts give money flows, of all transactions that involve the use of money or credit, with the financial relations between various segments of the economy, and with the relations between financial and non-financial transactions. Broadly speaking, the financial flow accounts reveal borrowing and lending operations of individual sectors from "whom to whom" and "in what manner" bases.

Flow-of-funds account and financial and non-financial flows: The flow of funds can be divided into the following two types:

1) **Financial Flows:** These flows cover all those transactions that relate to borrowing and lending operations resulting in borrowing or debt repayment and accumulation of or decrease in financial assets.

2) **Non-financial Flows:** These flows include all those transactions that relate to current receipts, current payments or current expenditures. These transactions should involve exchange of goods and services for money or near money holdings or unilateral transfers, such as, taxes, gifts, donations, etc, and the real assets formation including fixed assets formation and increase in inventories.

It would be noticed that non-financial transactions relate to the acquisition of goods and services and transfer payments, and financial transactions are concerned with the acquisition of financial assets and contraction of debts. For many analytic purposes, it is considered quite useful to distinguish in the non-financial transactions, the type of goods and services exchanged or the immediate purpose served by them. Similarly in the financial transactions, it is important to note the type of financial instruments used for payment or in exchange for other financial claims.

11.3 ORIGIN OF FLOW-OF-FUNDS SYSTEM OF ACCOUNTS

The origin of flow-of-funds account can be traced back to the year 1944. In that year, Professor Copeland was invited by the National Bureau of Economic Research "to direct an exploratory project to determine what could be done to provide a fuller statistical picture of the money circuit." In that study, he set out a conceptual framework to a detailed accounting framework for money flows.

Encouraged by Professor Copeland's work, the Board of Governors of Federal Reserve System of the United States in 1948 decided to continue with the study of the "flow-of-fund". In 1955, the concepts and methods of this system together with the relevant data and the sources of the material, were laid down in "Flow-of-Funds in the United States, 1939-53". Since 1959, the publication of flow-of-funds has been a regular publication. This practice was followed by a large number of other countries including Canada, Japan, Mexico, Italy, the Netherlands, France, West Germany, Norway, and Yugoslavia. There have been many conceptual and structural changes and refinements in the system of flow-of-funds accounts during the last so many years.

Check Your Progress 1

1) Define flow-of-funds system of accounts.

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2) Why is Flow-of-funds system of accounts is considered as the most comprehensive accounting system?

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3) Differentiate between financial flows and as non-financial flows.

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4) Discuss the origin of flow-of-funds accounts.

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11.4 FLOW-OF-FUNDS SYSTEM OF ACCOUNTS AND OTHER ACCOUNTING SYSTEMS

Flow of funds system of accounts can be differentiated from other systems namely national income accounting system, input-output system and the national balance sheet on the following grounds:

1) The central focus of each accounting system is different. Thus, National income accounting concentrates on: (i) measuring "output"; (ii) the uses in terms of the final purchases in the economy; and (iii) the types of factor income and other payments generated by economic activity.

   Input-output accounting is designed to study the way the technological production functions of various industries affect inter-industry relationships. In this manner, input-output accounting determines the industrial structure of the country.

   The National Balance Sheet shows the assets and liabilities of different sectors of the economy. This is closely related to flow-of-funds account except that it deals with stocks rather than flows. Similarly, National income accounts and input-output analysis deal with the flows during a year.

The scope of flow-of-funds accounting, on the other hand, is much more comprehensive. It sets forth the flow of payments and receipts, not only for goods and services but also for instruments of ownership and debt. It focuses on the sources and uses of funds that are essential for the support of economic activity. For instance, flow-of-funds system of accounts distinctly shows the purchase and sale of existing assets including transactions in land, tangible assets, and second hand goods. They exclude barter; book-keeping transfers of internal nature pertaining to a particular unit; intra-unit transactions and imputed transactions. Flow-of-funds therefore, do not contain any information on the real sector.

On the contrary, national accounts are not concerned with all those transactions linked to the receipt and payments of money or decrease (increase) in the credit (debit). There is no room for imputed incomes in the flow of funds system; but these are recorded and recognized in national accounts.

2) Flow-of-funds account employ different sector breakdown of the economy. The sectoring is designed in terms of both functional and institutional classifications. That reveals the borrowing and lending taking place in the system along with the income payments and purchases of goods and services. The sector classification in national income accounting is too consolidated. The sectoring has to be designed in terms of the functional aspects of economic activity. Therefore, consumers, producers, and government sectors are distinguished in addition of the rest of the world and saving and investment accounts. The classification adopted in input-output accounting highlights individual industries classified by the type of product produced and by the industrial processes used. This shows inputs consumed by each industry and the distribution of output produced by each industry. The sectoring although is much more detailed; it is not suitable for revealing the sources and uses of funds in the system.

3) The flow-of-funds sectoring has a different objective. It lays down a considerable stress on (a) financial institutions, including banking and insurance and (b) on differences in institutional forms of business and government, e.g., corporate vs. non-corporate, and central vs. state and local. The same is not true either about input-output table and national income accounting.

As shown above, different economic accounting systems have different purposes, and therefore, they should not be compared with each other in absolute terms. In fact, all these methods can play an important complementary role. All these accounting systems pertain to the same economy and are inter-linked. They also overlap or coincide for many transactions. They can be employed together as no single system can serve all purposes. However, they can be seen in terms of how efficiently they meet the purposes for which they were designed, and also, how important each of the various uses is in helping to solve the major problems facing the world today.

11.5 CONSTRUCTION AND PRESENTATION OF FLOW OF FUNDS ACCOUNTS

It has been brought out in the above pages that flow of funds system provides a statement of sources-and-uses-of-funds. It, in fact, is a hybrid accounting system. It combines sector's balance sheets and income statement. The most important points worth remembering while constructing and presenting these accounts are the following:

First, this system requires that the economy be divided into different sectors. The major sectors may be known as financial institutions, non-financial enterprises, Central and State Governments, households and private non-profit institutions. These sectors are further split into different categories.

Secondly, and this is very important, this framework of accounts uses quadruple entry system. That is, every transaction is recorded four times. For instance, suppose households purchase products worth Rs. 50 from some corporate firm, known as non-financial enterprise. There will be the following four entries:

i) Payment of money (Rs. 50) by the household sector;

ii) Acquisition of goods by the household sector worth Rs. 50;

iii) Goods parted away by the corporate firm worth Rs. 50;

iv) Receipt of money (Rs 50) by the corporate firm.

Thirdly, all the transactions represent receipts and payments and can be seen as flows of purchasing power. These can be further divided into financial and non-financial flows and also as sources and uses. Thus, money received can be treated as source, whereas its parting away with may termed as payment or use. From this a general rule may be deduced. That is, use would indicate acquisition of an asset or reducing a liability, whereas source would indicate disposing of an asset or incurring of a liability.

Fourthly, flow of funds accounts can be constructed in many ways, i.e., from a household account, balance sheet, and even from a balance of payment account.

Example I – Constructing flow of funds account from the transactions of an individual salary earner

One of the easiest methods is to understand the construction of flow of funds accounts is with the help of an account of an individual salary earner household. This is clear from the following hypothetical example:

Table 1: Transactions of an individual salary earner

Uses of funds		**Sources of funds**	
Consumption expenditure	183	Wages & Salary	153
Taxes	15	Transfers (Cur)	15
Rents paid	38	Consumers credit	30
Interest on loans	23	Interest on bank deposits	76
Construction of house	611	Rents from old property	8
Provident fund	15	Insurance claims	76
Payment. of insu. Premiums	15	Loans from office	458
Repayments of old debts	61	Loans from fin inst	153
Currency and deposits	38	Other loans	30
Total	999	Total	999

It may be noticed that double entry system is used to maintain the account book of a salary earner. The receipts are shown both as wages as well as currency and deposit. The consumption of Rs. 183 constitutes of cash purchases of

Rs. 152 and purchases from consumer's credit of Rs.30. The amount of Rs.38 shown as currency and deposits is the amount that represents the final outcome after all pluses and minuses have been added together. Data given above contains items of current and capital nature involving movement of goods and services and transfer payments or acquisition of financial assets and contracting debts.

The information given above can be translated into national accounts as well as flow of funds for the household sector in the following manner:

Table 2: National Accounts Showing Incomes and Outlays of an Individual Salary Earner

Outgoing		Incoming	
Consumption	183	Wages & Salary	153
Property income		Property income	
(i) Rent paid	38	(i) Interest on bank deposits	76
(ii) Interest on loans	23	(ii) Rents from old property	8
Taxes	15	Insurance claims	76
Insurance premium	15	Transfers (Current)	15
Saving	54		
Total	328	Total	328

It is also clear from the above data that sources of funds are equal to uses of funds in the following manner:

Sources of funds = Gross saving + increase in external financial liabilities
= Uses of funds
= Gross domestic capital formation + net financial investment abroad for the economy as a whole

Table 3: Capital Finance Accounts of an Individual Salary Earner

Outgoing		Incoming	
Gross capital formation	611	Savings	54
Net lending	-557	Capital consumption	
		Capital Transfers (net)	
Total	54	Total	54
Provident fund		Consumers' credit	30
Reduction of old debts		Loans from Government	458
Currency & deposits		Loans from Financial	153
		Institutions	30
		Other loans	557
		Net lending	
Total			114
		Total	
Net acquisition of financial assets		Net incurrence of liabilities & net lending	

Table 4: Flow of Funds Accounts of the Individual Salary Earner

Items	Sources	Uses
Non-financial		
Wages & Salaries	153	-
Rents	8	38
Interest	76	23
Dividends	-	-
Net withdrawal by proprietors	-	-
Insurance claims and premiums	76	15
Grants and donations	15	-
Taxes and tax refunds	-	15
Capital acquisitions	-	611
Purchases and sales of other goods & servs	-	183
Total	328	885
Financial		
Currency & deposits	-	38
Cent & State Govt Obligations	458	-
Mortgages	-	-
Corporate fin securities & loans	153	-
Provident funds	-	15
Other debts	30	61
Trade Credits	30	-
Total	671	114
Grand Total	999	999

On the above pattern, flow of funds accounts for all the households can be prepared. This exercise can be repeated for all the other sectors of the economy. Once we take the entire economy, income equals expenditure, and saving equals domestic capital formation plus net increase in foreign assets.

Method II – Constructing flow of funds with the help of a balance sheet

The other common method to construct flow of funds account is to make use of the balance sheet. The different steps are given below:

Step 1: Let us have a generalised balance sheet for any sector. It would appear something like the following:

Table 5: General Balance Sheet

Assets	Liabilities and Net Worth
A.Financial assets	C. Liabilities
1. Money	A. Short Term
2. Near Monies	B. Long Term
3. Others	
B. Real Assets	D. Net worth
Total assets (A+B)	Total liabilities (C+D)

Thus D = (A +B) – C

A balance sheet similar to the above (Table 1) can be drawn up for each sector.

However, there will be one important difference as regards the characteristic items that would appear under each heading. Each real asset appears only on one balance sheet, that is of its owner. On the contrary, each liability by its very nature as a debt must necessarily imply the existence of a liability of equal amount on some other balance sheet (s). Similarly, each financial asset must necessarily imply the existence of a liability of equal amount on some other balance sheet. Thus liabilities and assets in one sector may not be equal but for the entire economy they would be equal.

For the purpose of constructing flow of funds account, this balance sheet can be rearranged as follows:

Table 6: Rearranging the above Statement

Assets	**Liabilities & Net Worth**
1. Real Assets 2. Financial Assets 3. Money	4. Net Worth 5. Liabilities
Total Assets (1+2+3)	Total Liabilities (4+5)

Step 2: A balance sheet shows "stocks" as of moment in time rather than "flows" over a period of time. But data can be converted from stock to flow form by taking into account the changes in two balance sheets over the last two years.

In case we take into account financial assets and liabilities (ignoring real assets and net worth for the moment), we would get financial sources-and-uses-of-funds statement of a sector. It need not balance, since it is derived from partial rather than complete balance sheet. A financial use of funds for a sector (households, business firms, governments, and financial institutions) is to increase in its holdings of financial assets (lending) or to build up their stock of money (hoarding).

Step 3: Non-financial sources and uses are equally important and have to be considered. It is because a sector would also like to rely on those sources of funds. These sources may arise from current or capital account transactions. Changes in real assets and in net worth are non-financial transactions on capital account. Accordingly, the above balance sheet can be rearranged to take into account financial and non-financial uses and sources.

Table 7: Uses and Sources of Funds Shown in a Balance Sheet

Uses	**Sources**
Δ Real Assets (Investment) Δ Financial Assets (Lending) Δ Money (Hoarding)	Δ Net Worth (Saving) Δ Liabilities (Borrowing)
Total	Total

The symbol Δ denotes " changes in ".

The statement mentioned above (Table 7) is very useful. It shows that a deficit sector with investment greater than saving must dishoard, borrow or sell financial asset in an amount equal to its deficit. And, on the contrary, a surplus sector with saving exceeding investment must repay debt, hoard or lend an amount equal to its surplus.

Step 4: The statement discussed above is, however, incomplete. It does not take into explicit account of current transactions. That implies it ignores current receipts as a source of funds or current expenditures as a use or income statement. Incorporating current transactions, we get the following statement.

Table 8: Uses and Sources of Funds Shown in a Balance Sheet

Uses	**Sources**
Non-Financial Uses Current Expenditures Saving (Δ Net Worth) - - - - - - - - - - Δ Real Assets (Investment) Δ FA (Lending) Δ Money (Hoarding)	Non-Financial Sources Current Receipts - - - - - - - - - - Δ Net Worth (Saving) Δ Liabilities (Borrowing)
Total	Total

Δ=Changes in;

The excess of current receipts over current expenditures is generally termed as saving when it applies to the household sector; it is budget surplus in the case of government sector and retained earnings for business sector. As use of funds on current account, saving take the form of non-spending of accumulation or retention. As such, it becomes available as a source of funds for capital account and represents an addition to net worth.

Step 5: The above statement can be presented in the flow of funds matrix for a specified time period. It would appear as follows:

Table 9: Flow of Funds Matrix –Three Sector Economy

	Sec-A		Sec-B		Sec-C		All Sec	
	U	S	U	S	U	S	U	S
Saving (ΔNW)								
Investmt (ΔRA)								
Lending (ΔFA)								
Hoarding (ΔM)								
Borrowing (ΔL)								

Notes: NW = Net Worth; RA = Real Assets; FA = Financial Assets; M = Money; L = Liabilities.

This Statement is the most widely used form of sources and uses of funds statement. Since the income statement must balance and the changes in the balance sheet must balance, the summation of all the sources must equal the summation of all the uses of funds. The current receipts and current payments appear under Current Account, whereas the real assets formation and its financing appear under Capital Account.

The complete matrix of the flow of funds forms an interlocking self-contained system. It shows the balanced sources and uses-of-funds statements for each sector, the interrelations among the sectors and the aggregate totals of savings, investment, lending, hoarding, and borrowing for the economy as a whole.

11.6 APPLICATION OF FLOW-OF-FUNDS

Flow-of-funds accounting system is a comprehensive method. It furnishes information about sources and uses of funds accounts presented in the form of one large cross tabulation for all sectors. In these accounts, financial claims are ordered; users and suppliers of credit are identified; and owners of money in circulation and government debt and financial flows are integrated with the savings and investments of each major sector of the economy. This information and data are useful to the policy makers, economists and social scientists in indicating, as argued by Professor Copeland, "how our economy works". The specific uses are clear from the following points:

1) The analysis and examination of sector-wise flows and their interaction with the other individual sectors would help in identifying the problems relating to liquidity and its repercussions for the economy. For instance, when the economy is passing through the inflationary or deflationary phases, the flow of funds accounts would help in locating the sectors in which expansionary or contractionary pressures are building up.

2) The flow of funds accounts give an idea of all the real world changes in quantified terms that are related to economic institutions, the legal framework and the other institutional aspects. It is because money and credit flows are strongly influenced by the institutional, legal and other such arrangements of the economic system.

3) The study of the process in which transaction flows expand and contract would highlight the problems relating to economic fluctuations. For instance, the analysis of the structure of assets and liabilities of the different sectors will throw light upon the determinants of the changing behaviour overtime.

4) The flow-of-funds provides detailed sector-wise data on many financial and non-financial aspects. This information plays helps in analysing the changing pattern of liquidity in the different sectors of the economy. On this basis, indicators of financial development can be prepared. This information can be of great use for monetary analysis and capital market studies.

5) The sources and uses of funds of each sector portray the deficit or the surplus of each sector. Such accounts, for instance, would point out what kind of financial assets surplus sectors bought and what kinds of liability deficit sectors had incurred. These accounts will enable the government to design policies to channelise surplus funds for financing economic development.

6) Flow-of-funds accounts are useful in the field of financial planning and in indicating how the each sector is being financed. Sector-wise estimates of investment and saving give a good idea of the resources required to be mobilised for planning investment. Given this background, one can work out the probable effects of contemplated changes in economic policies.

7) Long term information on flow of funds helps in estimating the behaviouristic pattern of inter-sectoral disposition of funds and saving / investment variables. This system strives to link financial transactions and the financial structure of the economy with non-financial transactions and the productive structure of the economy. The accounting system, thus, explains the routes of financing the investment and also the interaction between economic activity and financial activity portraying simultaneously, the funds transacted between different economic units.

Check Your Progress 2

1) Differentiate among the different system of accounts.

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2) How are flow of funds accounts constructed and presented?

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3) What are the important uses and application of the flow of funds accounts?

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11.7 FLOW OF FUNDS ACCOUNTING PRACTICE IN INDIA

In 1955, Shri Deshmukh, the then Finance Minister, made a suggestion to construct flow-of-funds accounts. Some tentative arrangements were made in the year 1956 under the joint auspices of the Central Statistical Organisation (CSO) and the Reserve Bank of India (RBI). Consequently, an attempt was made in 1957 to build up the accounts for banking and corporate sectors for the First Plan Period.

In 1959, Prof. H.W. Arndt of the National University of Australia visited India at the invitation of the Indian Statistical Institute and he prepared a memorandum on “Financial Flows of Indian Economy, 1951/52-1957/8”. The economy was divided into four broad sectors, viz., government, banks, rest of the world, and residual. The analysis was confined to borrowing and lending only. The main object of the accounts was to show as to how and in what forms domestic savings had become available to government for financing its expenditure.

Later on, the work of Prof. Arndt, was broadened by the “Working Group” constituted for the purpose. The “Working Group” had representatives from Central Statistical Organisation, the RBI, the Ministry of Finance and the Indian Statistical Institute. The Report of the Working Group gave a very comprehensive account of Flow-of-Funds system of accounts. The Report had four sections. While presenting flow of funds accounts, the economy was divided into six sectors and 20 sub-sectors. Financial and non-financial transactions had ten categories. The Report gave the consolidated flow of funds accounts for the whole economy for the year 1957-58, in addition of the sectoral statements of sources and uses of funds separately both for financial and non-financial flows.

The RBI since then continued to improve methodology of constructing flow-of-funds system of accounts. These have also been published regularly. Following Bank's institutional classification, the Indian economy is divided into 6 broad sectors. They are: (1) banking (2) other financial institutions, (3) government, (4) private corporate business, (5) rest of the world and (6) households (residual). Each of these sectors is further divided into sub-sectors. Dis-aggregation of the sectors depends upon the availability of data of different institutions. The household sector includes individuals, households or consumers, non-corporate non-farm business, farm business, private non-profit organisations and all other units not covered in other institutional sectors. Flow of fund accounts, also require classification of the transactions into economically meaningful groups. These transactions are classified both instrument-wise as well as sector-wise. Their detailed accounts are given in Table 10 and Table 12.

These tables show the following points:

1) Total claims are issued by the financial and non-financial sectors. The former includes banking and other financial institutions and the latter includes private corporate business, government, rest of the world and the households.

2) The proportionate share of all the financial institutions (in uses) is about 26 per cent as compared to 74 per cent share of the non-financial sectors. The increased share of the non-financial sectors would indicate that secondary issues are considered more important as compared to the primary issues. A rising share of the financial institutions over the period would generally indicate the increasing financial intermediation in the economy.

3) Among the non-financial sectors, the leading sectors are the Government followed by private corporate sector and the household sector.

4) The most important instruments (as uses) in the Indian economy are loans and advances followed by currency and deposits, investments and provident funds. Within investments, the leading instrument is central and State governments followed by corporate securities.

5) The resource gap defined as the saving-investment gap adjusted for capital transfers can be worked out by taking the difference between sources and uses. These gaps are found both in sector-wise as well as instrument-wise financial flows. This is found very high in the case of Central and State Government securities. In case, investment of a sector is in excess of savings generated by it, this implies that this sector borrows directly from other sectors by issuing claims on them which are held by sectors having surplus resources as also through borrowings from the financial intermediaries.

11.8 LIMITATIONS OF FLOW-OF-FUNDS ACCOUNTS

i) **Problem of Sectorisation:** The most important problem in the construction of flow of funds accounts is the division of economy into homogenous and meaningful sectors. A sector represents a group of transactions that have common characteristics capable of being distinguished for the purpose of analysis.

Sectorization of the economy is a difficult area because there are too many conceptual as well as statistical problems. Two most important conceptual problems relate to, one, Sectorisation and two, definition of each sector.

The criteria for identifying and delimiting the economic units which are to be brought together be, (i) Sectors should include all the activities of any economic unit; (ii) each sector be limited to units which show generally similar reactions to change in their assets and liabilities. The second conceptual problem relates to, whether the definition of each sector should be made on an institutional basis or on a functional basis. While defining a sector, one has to consider (a) the activity-financial or real (b) the functional homogeneity, (c) the institutional homogeneity and (d) data availability. One may observe that there quite often, appear a clash between institutional and functional classification of sectors. However, the sectoral classification should depend upon the institutional set up of the economy and also keeping in view the purpose for which the accounts are utilised.

ii) **Presentation of accounts either on gross or net basis**. Financial flow accounts can be presented both on gross or net basis. Generally speaking, the gross transactions are preferable to net transactions for analytical purposes and also because the latter may conceal significant deviations in behaviour. However, the presentation of accounts on a gross basis depends on the availability of data and the form in which they are available for each sector.

iii) **Consolidation of accounts**: The accounts of each institution or sub-sector have to be consolidated as transactions in each sector are presented 'from whom-to-whom' basis and sector-wise classification is presented under each instrument. In consolidating the accounts, intra sub-sector transactions are eliminated. This however, depends on the adequate availability of data.

iv) **Valuation of transactions:** Transactions are recorded at the price at which they are sold or purchased. However, the same price may or may not be reported by the seller and the purchaser because the value reported in their books of accounts may be book value of face value or current market prices

v) **Selection of Accounting Period**: The accounting period set for the flow of funds accounts is April-March. The period is also the same in the case of national income accounts. However, the accounting period is not common for all the institutions or sub-sectors of the Indian economy. These sectors include cooperative banks and societies (July-June); insurance companies (January-December) and financial corporations (July-

June). All these accounting periods have to be approximated for April to March for the purpose of flow of funds accounts.

vi) **Discrepancies**: In principle, the flow of funds account constitutes an interlocking and balancing set of accounts. Total sources of funds become equal to total uses of funds for each sector. However, at the economy level, discrepancies between total financial sources of funds and total financial uses of funds arise due to many factors. These include factors like timing, valuation, coverage, classification and such statistical inadequacies relating to error in basis data or omission of pertinent transaction or transactors.

Check Your Progress 3

1) Write a brief note on the historical background of the first flow of funds account in India.

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2) Name the different sectors in which Indian economy is divided for the purpose of "sources and uses of funds" statement?

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3) Discuss the limitations of flow-of-funds accounts.

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11.9 LET US SUM UP

National Income accounts measure the output, income, expenditure, saving and investment of the economy for a given period of time. The Balance of Payment accounts present the transactions of the domestic economy with the rest of the world. These accounts, however, do not give full information, as financial flows remain ignored in these accounts The Flow of Funds Accounts represents a set of accounts designed to show transactions between different economic units effected through medium of money and credit. The flow of funds, thus, is a system of social accounting that gives a statement of the "sources-and-uses-of-funds" of the each sector in which the economy is divided.

Flow of funds accounts covers both financial and non-financial transactions. Financial transactions are concerned with the acquisition of financial assets and contraction of debts. Non-financial transactions, on the other hand, relate to the acquisition of goods and services and transfer payments.

The origin of flow-of-funds account is attributed to the work of Professor Copeland in 1944. This system is different from other systems. These systems can be seen in terms of, the central focus of these accounts, the sector-wise breakdown of the economy, and the objectives underlying the construction of different types of accounts..

The information and data provided in flow of funds serve a useful purpose. The important users include policy makers, economists and social scientists. As argued by Professor Copeland, flow of funds, indicate "how our economy works". For instance, flow of funds accounts facilitate the nature of the interrelationships of the financial and non-financial variables, their functioning and its implications for the economy. This information can be used for better monetary planning and also for future projections.

In India, the first time attempt was made 1956 under the joint auspices of the Central Statistical Organisation (CSO) and the Reserve Bank of India (RBI). As a result, in 1957, the accounts for banking and corporate sectors for the First Plan Period were constructed. The most important problems encountered while constructing the flow of funds accounts relate to, the division of economy into homogenous and meaningful sectors, presentation of accounts either on gross or net basis, consolidation of accounts and deficiencies arising from differences in reporting, timing, valuation, as well as estimation procedures.

11.10 KEY WORDS

Flow-of-funds : The flow of funds, thus, is a system of social accounting that gives a statement of the "sources-and-uses-of-funds" of the each sector in which the economy is divided.

Financial Flows : Financial transactions are concerned with the acquisition of financial assets and contraction of debts.

Input-Output Accounts : Input-output accounting is designed to study the way the technological production functions of various industries affect inter-industry relationships. In this manner, input-output accounting determines the industrial structure of the country.

Non-financial Flows : Non-financial transactions relate to the acquisition of goods and services and transfer payments.

Sector : A sector represents a group of transactions that have common characteristics capable of being distinguished for the purpose of analysis.

"Sources" and "uses" of funds : These terms are used in flow of funds particularly in order to differentiate between receipts and payments, or "incoming" and "outgoing". The use of "sources" and" funds" is preferred because payments generally convey the meaning of spending as well as lending and do not include the increases in money held. Similarly, "receipts" or "incomings" do not cover the funds available for investment or uses out of the depletion of money held in hand or in a bank.

Stock and flow variables : Stock variables are measures at a particular point of time whereas flow variables are measured over time. For instance, balance sheet represents a stock situation whereas profit and loss account represents flow situation. Similarly, capital is a stock variable whereas investment is a flow variable.

11.11 SOME USEFUL BOOKS

Central Statistical Organisation (1963) (CSO), Government of India: Report of the Working Group on Flow of Funds, New Delhi.

Roy Choudhuri, Uma Datta (1995) National Income Accounting, Macmillan, New Delhi.

11.12 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See secion 11.2
2) See secion 11.2
3) See secion 11.2
4) See secion 11.3

Check Your Progress 2

1) See secion 11.4
2) See secion 11.5
3) See secion 11.6

Check Your Progress 3

1) See secion 11.7
2) See secion 11.7
3) See secion 11.8