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Management accounting

(Questions and Answers)

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1. Funds flow Statement

Fund flow statement shows the inflow and outflow of fund of an organization, it provide complete information about the fund investment.

Fund flow statement explain the how much fund go outside and inside, in this way it help to know the financial position of the organization if inflow is more than outflow it means company is financially strong.

2. Break even point

Point at which Total cost is equals to Total Revenue (TR =TC) No profit and no loss point

Where total cost = Total Fixed cost and Total Variable cost i.e., cost of making a product

Total revenue is Realised by making sale of the product produced

BEP is a level at which neither profit nor loss situation.

3. Zero Based Budgeting:

A method of budgeting in which all expenses must be justified for each new period. Zero- based budgeting starts from a "zero base" and every function within an organization is analyzed for its needs and costs. Budgets are then built around what is needed for the upcoming period, regardless of whether the budget is higher or lower than the previous one.

ZBB allows top-level strategic goals to be implemented into the budgeting process by tying them to specific functional areas of the organization, where costs can be first grouped, then measured against previous results and current expectations.

4. Master Budget

Set of operating budgets related to finance, operations, production, sales, etc., and including projected (pro forma) cashflow statement, income statement, and balance sheet.

5. Weighted Average Cost of Capital

The weighted average cost of capital (WACC) is the rate that a company is expected to pay on average to all its security holders to finance its assets.

The WACC is the minimum return that a company must earn on an existing asset base to satisfy its creditors, owners, and other providers of capital, or they will invest elsewhere. Companies raise money from a number of sources: common equity, preferred equity, straight debt, convertible debt, exchangeable debt, warrants, options, pension liabilities, executive stock options, governmental subsidies, and so on. Different securities are expected to generate different returns. The WACC is calculated taking into account the relative weights of each component of the capital structure and is used to see if the investment is worthwhile to undertake.

6. Concepts of working capital

There are two definitions of working capital (1) Gross working capital (2) Net working capital

Gross working capital refers to working capital as the total of current assets, whereas the net working capital refers to working capital as excess of current assets over current liabilities. In other words net working capital refers to current assets financed by long term funds.

Accordingly,

Gross working capital = Total current assets

Net working capital = Current assets – Current liabilities

7. Accounting Ratios/Uses and Limitations

Definition of Accounting Ratios:

The term "accounting ratios" is used to describe significant relationship between figures shown on a balance sheet, in a profit and loss account, in a budgetary control system or in any other part of accounting organization. Accounting ratios thus shows the relationship between accounting data.

Ratios can be found out by dividing one number by another number. Ratios show how one number is related to another. It may be expressed in the form of co-efficient, percentage, proportion, or rate. For example the current assets and current liabilities of a business on a particular date are $200,000 and $100,000 respectively. The ratio of current assets and current liabilities could be expressed as 2 (i.e. 200,000 / 100,000) or 200 percent or it can be expressed as 2:1 i.e., the current assets are two times the current liabilities. Ratio sometimes is expressed in the form of rate. For instance, the ratio between two numerical facts, usually over a period of time, e.g. stock turnover is three times a year.

8. Advantages of Ratios Analysis:

Ratio analysis is an important and age-old technique of financial analysis. The following are some of the advantages / Benefits of ratio analysis:

1. Simplifies financial statements: It simplifies the comprehension of financial statements.

Ratios tell the whole story of changes in the financial condition of the business

2. Facilitates inter-firm comparison: It provides data for inter-firm comparison. Ratios highlight the factors associated with with successful and unsuccessful

firm. They also reveal strong firms and weak firms, overvalued and undervalued firms.

3. Helps in planning: It helps in planning and forecasting. Ratios can assist management, in its basic functions of forecasting. Planning, co-ordination, control and communications.

4. Makes inter-firm comparison possible: Ratios analysis also makes possible comparison of the performance of different divisions of the firm. The ratios are helpful in deciding about their efficiency or otherwise in the past and likely performance in the future.

5. Help in investment decisions: It helps in investment decisions in the case of investors and lending decisions in the case of bankers etc.

9. Limitations of Ratios Analysis:

The ratios analysis is one of the most powerful tools of financial management. Though ratios are simple to calculate and easy to understand, they suffer from serious limitations.

1. Limitations of financial statements: Ratios are based only on the information which has been recorded in the financial statements. Financial statements themselves are subject to several limitations. Thus ratios derived, there from, are also subject to those limitations. For example, non-financial changes though important for the business are not relevant by the financial statements. Financial statements are affected to a very great extent by accounting conventions and concepts. Personal judgment plays a great part in determining the figures for financial statements.

2. Comparative study required: Ratios are useful in judging the efficiency of the business only when they are compared with past results of the business. However, such a comparison only provide glimpse of the past performance and

forecasts for future may not prove correct since several other factors like market conditions, management policies, etc. may affect the future operations.

3. Ratios alone are not adequate: Ratios are only indicators, they cannot be taken as final regarding good or bad financial position of the business. Other things have also to be seen.

4. Problems of price level changes: A change in price level can affect the validity of ratios calculated for different time periods. In such a case the ratio analysis may not clearly indicate the trend in solvency and profitability of the company. The financial statements, therefore, be adjusted keeping in view the price level changes if a meaningful comparison is to be made through accounting ratios.

5. Lack of adequate standard: No fixed standard can be laid down for ideal ratios. There are no well accepted standards or rule of thumb for all ratios which can be accepted as norm. It renders interpretation of the ratios difficult.

6. Limited use of single ratios: A single ratio, usually, does not convey much of a sense.

To make a better interpretation, a number of ratios have to be calculated which is likely to confuse the analyst than help him in making any good decision.

7. Personal bias: Ratios are only means of financial analysis and not an end in itself. Ratios have to interpreted and different people may interpret the same ratio in different way.

8. Incomparable: Not only industries differ in their nature, but also the firms of the similar business widely differ in their size and accounting procedures etc. It makes comparison of ratios difficult and misleading.

10. Budgetary control

Methodical control of an organization's operations through establishment of standards and targets regarding income and expenditure, and a continuous monitoring and adjustment of performance against them.

Uses

Like other control methods, budgets have the potential to help organizations and their members reach their goals. Budget control offers several advantages to managers. Some of these are:

The major strength of budgeting is that it coordinates activities across departments.

Budgets translate strategic plans into action. They specify the resources, revenues, and activities required to carry out the strategic plan for the coming year.

· Budgets provide an excellent record of organizational activities.

· Budgets improve communication with employees.

· Budgets improve resources allocation, because all requests are clarified and justified.

· Budgets provide a tool for corrective action through reallocations.

11. Choice of investors- The company's policy generally is to have different categories of investors for securities. Therefore, a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors.

12. Period of financing- When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.

13. Cost of financing- In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits.

14. Stability of sales- An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments. Interest on debentures has to be paid regardless of profit. Therefore, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases.

15. Management accounting or managerial accounting is concerned with the provisions and use of accounting information to managers within organizations, to provide them with the basis to make informed business decisions that will allow them to be better equipped in their management and control functions.

In contrast to financial accountancy information, management accounting information is: designed and intended for use by managers within the organization, instead of being intended for use by shareholders, creditors, and public regulators; usually confidential and used by management, instead of publicly reported; forward-looking, instead of historical; computed by reference to the needs of managers, often using management information systems, instead of by reference to general financial accounting standards.

16. Users of accounting information

Cost and management accounting – provision of information to managers to help them in decision-making, planning and control.

Financial accounting – provision of information to external users outside the business.

17. Funds flow Statement

“A statement of Sources and Application of Funds is a technical device designed to analyse the changes in the financial condition of a business enterprises between two dates.”

Funds Flow Statement is not an income statement . Income statement shows the items of income and expenditure of a particular period, but the Funds flow statement is an operating statement as it summaries the financial activities for a period of time. It covers all movements that involve an actual exchange of assets.

Various titles are used for this statement such as 'Statement of sources and Application of Funds', 'Summary of Financial operations,' 'Changes in Financial Position', 'Fund received and Disbursed', 'Funds Generated and Expended', Changes in Working Capital”, “Statement of Fund' etc. Title of Funds Flow Statement has been modified from time to time. Really it is very difficult to find a short time for such statement which carries much to the readers regarding its contents an functions.

A new interpretation of the term 'funds, has now been adopted as to include assets or financial resourceful which do not flow through the working capital accounts. It seems to be the most suitable meaning fort the term 'funds' but the most commonly used interpretation of the term 'funds' is 'working capital'

18. Cash flow statement

The cash flow statement, also known as statement of cash flows or funds flow statement, is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities. Essentially, the cash flow statement is concerned with the flow of cash in and cash out of the business. The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills. International Accounting Standard 7 (IAS 7), is the International Accounting Standard that deals with cash flow statements.

19. Financial statement analysis is defined as the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account.

There are various methods or techniques that are used in analyzing financial statements, such as comparative statements, schedule of changes in working capital, common size percentages, funds analysis, trend analysis, and ratios analysis.

Financial statements are prepared to meet external reporting obligations and also for decision making purposes. They play a dominant role in setting the framework of managerial decisions. But the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from these statements alone. However, the information provided in the financial statements is of immense use in making decisions through analysis and interpretation of financial statements.

20. Tools and Techniques of Financial Statement Analysis:

Following are the most important tools and techniques of financial statement analysis:

1. Horizontal and Vertical Analysis

2. Ratios Analysis

1. Horizontal and Vertical Analysis:

Horizontal Analysis or Trend Analysis:

Comparison of two or more year's financial data is known as horizontal analysis, or trend analysis. Horizontal analysis is facilitated by showing changes between years in both dollar and percentage form. Click here to read full article.

Trend Percentage:

Horizontal analysis of financial statements can also be carried out by computing trend percentages. Trend percentage states several years' financial data in terms of a base year. The base year equals 100%, with all other years stated in some percentage of this base. Click here to read full article.

Vertical Analysis:

Vertical analysis is the procedure of preparing and presenting common size statements. Common size statement is one that shows the items appearing on it in percentage form as well as in dollar form. Each item is stated as a percentage of some total of which that item is a part.

Key financial changes and trends can be highlighted by the use of common size statements. Click here to read full article.

21. Ratios Analysis:

Accounting Ratios Definition, Advantages, Classification and Limitations:

The ratios analysis is the most powerful tool of financial statement analysis. Ratios simply means one number expressed in terms of another. A ratio is a statistical yardstick by means of which relationship between two or various figures can be compared or measured. Ratios can be found out by dividing one number by another number. Ratios show how one number is related to another. Click here to read full article.

22. Profitability Ratios:

Profitability ratios measure the results of business operations or overall performance and effectiveness of the firm. Some of the most popular profitability ratios are as under: Gross profit ratio

Net profit ratio

Operating ratio

Expense ratio

Return on shareholders investment or net worth

Return on equity capital

Return on capital employed (ROCE) Ratio

Dividend yield ratio

Dividend payout ratio

Earnings Per Share Ratio

Price earning ratio

23. Liquidity Ratios:

Liquidity ratios measure the short term solvency of financial position of a firm. These ratios are calculated to comment upon the short term paying capacity of a concern or the firm's ability to meet its current obligations. Following are the most important liquidity ratios.

Current ratio

Liquid / Acid test / Quick ratio

24. Activity Ratios:

Activity ratios are calculated to measure the efficiency with which the resources of a firm have been employed. These ratios are also called turnover ratios because they indicate the speed with which assets are being turned over into sales. Following are the most important activity ratios:

Inventory / Stock turnover ratio

Debtors / Receivables turnover ratio

Average collection period

Creditors / Payable turnover ratio

Working capital turnover ratio

Fixed assets turnover ratio

Over and under trading

25. Long Term Solvency or Leverage Ratios:

Long term solvency or leverage ratios convey a firm's ability to meet the interest costs and payment schedules of its long term obligations. Following are some of the most important long term solvency or leverage ratios.

Debt-to-equity ratio

Proprietary or Equity ratio

Ratio of fixed assets to shareholders funds

Ratio of current assets to shareholders funds

Interest coverage ratio

Capital gearing ratio

Over and under capitalization

26. Capital budgeting (or investment appraisal) is the planning process used to determine whether a firm's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects are worth pursuing. It is budget for major capital, or investment, expenditures.

Many formal methods are used in capital budgeting, including the techniques such as

Accounting rate of return

Net present value

Profitability index

Internal rate of return

Modified internal rate of return

Equivalent annuity

These methods use the incremental cash flows from each potential investment, or project Techniques based on accounting earnings and accounting rules are sometimes used - though economists consider this to be improper - such as the

accounting rate of return, and "return on investment." Simplified and hybrid methods are used as well, such as payback period and discounted payback period.

27. Standard Costing.

The CIMA, London has defined standard cost as “a predetermined cost which is calculated from managements standards of efficient operations and the relevant necessary expenditure.” They are the predetermined costs on technical estimate of material labour and overhead for a selected period of time and for a prescribed set of working conditions. In other words, a standard cost is a planned cost for a unit of product or service rendered.

The technique of using standard costs for the purposes of cost control is known as standard costing. It is a system of cost accounting which is designed to find out how much should be the cost of a product under the existing conditions. The actual cost can be ascertained only when production is undertaken. The predetermined cost is compared to the actual cost and a variance between the two enables the management to take necessary corrective measures.

28. Working capital (abbreviated WC) is a financial metric which represents operating liquidity available to a business, organization, or other entity, including governmental entity. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital. It is calculated as current assets minus current liabilities. If current assets are less than current liabilities, an entity has a working capital deficiency, also called a working capital deficit. Net working capital is working capital minus cash (which is a current asset) and minus interest bearing liabilities (i.e. short term debt). It is a derivation of working capital, that is commonly used in valuation techniques such as DCFs (Discounted cash flows).

Working Capital = Current Assets − Current Liabilities

A company can be endowed with assets and profitability but short of liquidity if its assets cannot readily be converted into cash. Positive working capital is required to ensure that a firm is able to continue its operations and that it has sufficient funds to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable and cash.