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Cost and Management accounting

(Questions and Answers)

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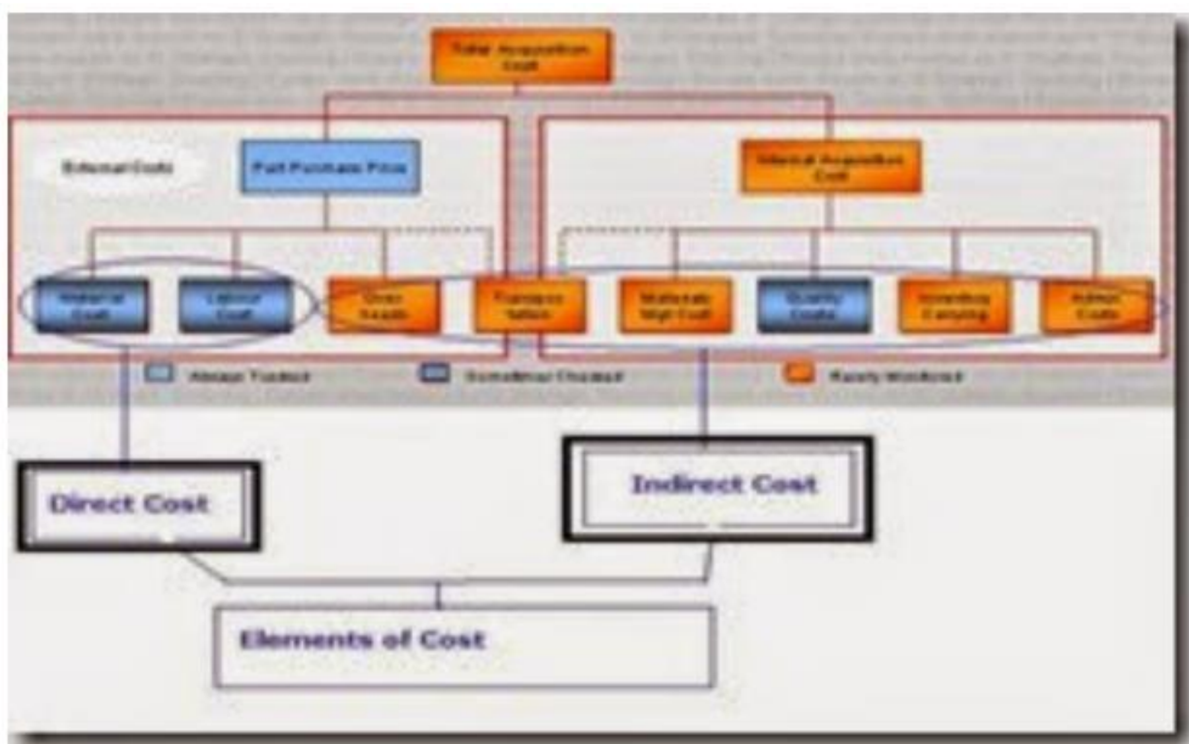
1. Funds flow Statement

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. Elements of cost



3. 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.

4. 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.

5. 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.

6. Goals of Financial management

Maximisation Gosl

Minimisation Goal

Profit

Profitablility Liquidity Solvency

Earnings Per Share

Cost

Risk

7. 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.

8. Optimum Capital Structure

Capital Structure: A company's ratio of long-term debt to equity.

Optimal Capital Structure: A "best" debt/equity ratio for a company. This is the debt/equity ratio that will minimize the cost of capital, i.e., the cost of financing the company's operations.

9. 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

10. 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.

11. 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.

12. 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.

13. 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.

14. Factors affect the capital structure

The capital structure refers to the way a corporation finances its assets through some combination of equity, debt, or hybrid securities. A firm's capital structure is then the composition or 'structure' of its liabilities.

Capital Structure is referred to as the ratio of different kinds of securities raised by a firm as long-term finance. The capital structure involves two decisions-

a. Type of securities to be issued are equity shares, preference shares and long term borrowings(Debentures)

b. Relative ratio of securities can be determined by process of capital gearing. On this basis, the companies are divided into two-

a. Highly geared companies- Those companies whose proportion of equity capitalization is small.

b. Low geared companies- Those companies whose equity capital dominates total capitalization.

For instance - There are two companies A and B. Total capitalization amounts to be Rs.20 lakh in each case. The ratio of equity capital to total capitalization in company A is Rs.5 lakh, while in company B, ratio of equity capital is Rs.15 lakh to total capitalization, i.e, in Company A, proportion is 25% and in company B, proportion is 75%. In such cases, company A is considered to be a highly geared company and company B is low geared company.

15. Trading on Equity- The word "equity" denotes the ownership of the company. Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares. It is based on the thought that if the rate of dividend on preference capital and the rate of interest on borrowed capital is lower than the general rate of company's earnings, equity shareholders are at advantage which means a company should go for a judicious blend of preference shares, equity shares as well as debentures. Trading on equity becomes more important when expectations of shareholders are high.

16. Degree of control- In a company, it is the directors who are so called elected representatives of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights.