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Cost and Management accounting

(Questions and Answers)

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1. Flexibility of financial plan- In an enterprise, the capital structure should be such that there is both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plans. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.

2. 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.

3. Capital market condition- In the lifetime of the company, the market price of the shares has got an important influence. During the depression period, the company's capital structure generally consists of debentures and loans. While in period of boons and inflation, the company's capital should consist of share capital generally equity shares.

4. 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.

5. 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.

6. 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.

7. Sizes of a company- Small size business firms capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.

8. 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.

9. 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.

10. 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'

11. 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.

12. People and groups interested in cash flow statements include: Accounting personnel, who need to know whether the organization will be able to cover payroll and other immediate expenses Potential lenders or creditors, who want a clear picture of a company's ability to repay Potential investors, who need to judge whether the company is financially sound Potential employees or contractors, who need to know whether the company will be able to afford compensation Shareholders of the business.

13. 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.

14. 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.

15. 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.

16. 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

17. 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

18. 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

19. 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

20. 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.

21. 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 labor 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.

22. 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.