Valluvar College of Science and Management

Department of Business Administration

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UNIT 1

Management Accounting Meaning:

The term management accounting refers to accounting for the management. Management accounting provides necessary information to assist the management in the creation of policy and in the day – to – day operation. It enables the management to discharge all its functions i.e. planning, organization, staffing, direction and control efficiently with the help of accounting information.

Definition:

"Management Accounting is concerned with accounting information that is useful to management." – R.N.ANTHONY.

Objectives of Management Accounting:

The objectives of management accounting are:

1) To assist the management in promoting efficiency. Efficiency includes best possible services to the customers, investors and employees.
2) To prepare budgets covering all functions of a business (i.e. Production, sales, research and finance).
3) To analyses monetary and non - monetary transaction.
4) To compare the actual performance with plan for identifying deviations their causes.
5) To interpret financial statements to enable the management to formulate future policies.
6) To submit to the management at frequent intervals operating statements and short – term financial statements.
7) To arrange for the systematic allocation of responsibilities.
8) To provide a suitable organization for discharging the responsibilities.

Scope and Functions of Management Accounting:

The scope of management accounting is very wide. It includes with in its fold all aspects of business operations. The following areas indicate the scope of management accounting.

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1) **Financial accounting:** Financial accounting provides historical information. It forms the basis for the future planning and financial forecasting. A properly designed financial accounting. System is a must securing full control and co – ordination of business operations.
2) **Cost Accounting:** Cost accounting provides various techniques of costing like marginal costing. Standard costing, operation costing etc. these techniques play an important role in assisting the management in the formulation of policy and the operation of the undertaking.
3) **Budgetary control:** This includes framing of budgets, comparison of actual performance with budgeted performance, computation of variances, finding
4) **Inventory Control:** It is concerned with control over inventory form the time it is received till its disposal.
5) **Reporting:** Reporting includes the preparation of monthly, quarterly, half yearly income statements and other related reports such as cash flow and funds flow statements.
   These reports are submitted to the management for evaluation of performance and decision – making.

6) **Statistical Methods:** Statistical tools like graphs, charts, index numbers etc., are used for presentation of information to various departments.
7) **Taxation:** It includes preparation of income statements, assessing the effect of tax on capital expenditure proposals and pricing.
8) **Methods and Procedures:** They deal with organizational methods for cost reduction, procedures for improving the efficiency of accounting and office operations.
9) **Internal Audit:** This refers to the establishments of a suitable internal audit system for internal control.
10) **Office Services:** They cover a wide range of activities like data processing, filing, copying, printing, communication etc.,

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Function of Management Accounting:

A function of management accounting includes all activities connected with collecting, processing, interpreting and presenting information to the management. The main functions of management accounting are:

1) **Forecasting:** Making short – term and long – term forecasts and planning the future operations of the business.
2) **Organizing:** Organizing the human and physical resources of the business. This is done by assigning specific responsibilities to different people.
3) **Co – Ordination:** Providing different tools of co – ordination. Examples of such tools are budgeting, financial reporting, financial analysis, interpretation etc.

5) **Analysis and Interpretation:** Analyzing and interpreting financial data in a simple and purposeful manner.
6) **Communicating:** Communicating the results of business activities through prompt and accurate reporting system.
7) **Economic Appraisal:** Appraising of social and economic forces and government policies and interpreting their on business.

Advantages and limitation of management accounting:

The Advantages of management accounting are summarized below.

1) **Helps in Decision Making:** Management accounting helps in decision making such as pricing, make or buy, acceptance of additional orders, selection of suitable product mix etc. These important decisions are taken with the help of marginal costing technique.
2) **Helps in Planning:** Planning includes profit planning, preparation of budgets programmes of capital investment and financing. Management is accounting assist in planning through budgetary control, capital budgeting and cost – volume – profit analysis.
3) **Helps in Organizing:** Management accounting uses various tools and techniques like budgeting, responsibility accounting and standard costing. A sound organizational structure is developed to facilitate the use of these techniques.
4) **Facilitates Communication:** Management is provided with up – to – date information through periodical reports. These reports assist the management in the evaluation of performance and control.
5) **Helps in Coordinating:** The functional budgets (purchase budget, sales budget, overhead budgets etc.) are integrated into one known as master budget. This facilitates clear definition of department goals and co – ordination of their activities.
6) **Intuitive decisions:** management accounting helps in scientific decision making. Yet, because of simplicity and personal factors the management has a tendency to arrive at decisions by intuition.
7) **Not an alternative to management:** management accounting will not replace the management and administration. It is a tool of the management. Decisions are of the management and not the management accountant

Distinguish between management accounting and financial accounting.

The following are the main differences between financial accounting and management accounting.

1) **Objectives:** the main objective of financial accounting is to supply information in the form of profit and loss account and balance sheet to outside parties like shareholders, creditors, government etc. but the objective of management accounting is to provide information for the internal use of management.

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2) **Performance Analysis:** financial accounting is concerned with the overall performance of the business. On the other hand management accounting is concerned with the departments or divisions. It reports about the performance and profitability of each of them.
3) **Data Used:** financial accounting is mainly concerned with the recording of post events whereas managements accounting is concerned with future plans and policies.
4) **Nature:** financial accounting is based on measurement while management accounting is based on judgment. Because of this, financial accounting is more objective and management accounting is more subjective.
5) **Accuracy:** accuracy is an important factor in financial accounting. But approximations are widely used in management accounting. This is because most of the information is related to the future and intend for internal use.
6) **Legal compulsion:** financial accounting is compulsory for all joint stock companies but management accounting is only optional.
7) **Monetary Transactions:** financial accounting records only those transactions which can be expressed in terms of money. On the other hand, management accounting records not only monetary transactions but also non –monetary events, namely technical changes, government polices etc.
8) **Control:** financial accounting will not reveal whether plans are properly implemented. Management accounting will reveal the deviations of actual performance from plans. It will also indicate the causes for such deviations.

Distinguish between cost accounting and management accounting.

1) **Objective:** The objective of cost accounting is the ascertainment and control of costs of products or services. But the objective of management accounting is to help the management in decision making, planning, control etc. this objective is achieved by furnishing relevant accounting information to the management.

2) **Scope:** Cost accounting deals primary with cost data. But management accounting deals with both cost and revenue. It includes financial accounting, cost accounting, budgeting, reporting to management and interpretation of financial data. Thus, the scope of management accounting is wider than that of cost accounting.

3) **Data Used:** in cost accounting, only those transactions which can be expressed in figures are taken. Only quantitative aspect is recorded in cost accounting. But management accounting uses both quantitative and qualitative information.

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4) **Nature:** Cost accounting uses both past and present figures. But management accounting is concerned with the projection of figures for future. The policies and plans are prepared for providing future guideline.

FINANCIAL STATEMENTS ANALYSIS

In order to ascertain the financial status of the business every enterprise prepares certain statements, known as financial statements. Financial statements are mainly prepared for decision making purposes. But the information as is provided in the financial statements is not adequately helpful in drawing a meaningful conclusion.

Analysis means establishing a meaningful relationship between various items of the two financial statements with each other in such a way that a conclusion is drawn. By financial statements we mean two statements:

(i) Profit and loss Account or Income Statement
(ii) Balance Sheet or Position Statement

Financial analysis serves the following purposes:

1. **Measuring the profitability**

The main objective of a business is to earn a satisfactory return on the funds invested in it. Financial analysis helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. It also helps in knowing the capacity to pay the interest and dividend.

2. **Indicating the trend of Achievements**

Financial statements of the previous years can be compared and the trend regarding various expenses, purchases, sales, gross profits and net profit etc. can be ascertained. Value of assets and liabilities can be compared and the future prospects of the business can be envisaged.

3. **Assessing the growth potential of the business**

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The trend and other analysis of the business provide sufficient information indicating the growth potential of the business.

4. **Comparative position in relation to other firms**

The purpose of financial statements analysis is to help the management to make a comparative study of the profitability of various firms engaged in similar businesses. Such comparison also helps the management to study the position of their firm in respect of sales, expenses, profitability and utilizing capital, etc.

5. **Assess overall financial strength**

The purpose of financial analysis is to assess the financial strength of the business. Analysis also helps in taking decisions, whether funds required for the purchase of new machines and equipments are provided from internal sources of the business or not if yes, how much? And also to assess how much funds have been received from external sources.

6. **Assess solvency of the firm**

The different tools of an analysis tell us whether the firm has sufficient funds to meet its short term and long term liabilities or not.

PARTIES INTERESTED IN FINANCIAL STATEMENT

Analysis of financial statements has become very significant due to widespread interest of various parties in the financial results of a business unit. The various parties interested in the analysis of financial statements are :

(i) **Investors :**

Shareholders or proprietors of the business are interested in the well being of the business. They like to know the earning capacity of the business and its prospects of future growth.

(ii) **Management :**

The management is interested in the financial position and performance of the enterprise as a whole and of its various divisions. It helps them in preparing budgets and assessing the Performance of various departmental heads.

(iii) **Trade unions :**

They are interested in financial statements for negotiating the wages or salaries or bonus agreement with the management.

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(iv) **Lenders :**

Lenders to the business like debenture holders, suppliers of loans and lease are interested to know short term as well as long term solvency position of the entity.

(v) **Suppliers and trade creditors :**

The suppliers and other creditors are interested to know about the solvency of the business i.e. the ability of the company to meet the debts as and when they fall due.

(vi) **Tax authorities :**

Tax authorities are interested in financial statements for determining the tax liability.

(vii) **Researchers :**

They are interested in financial statements in undertaking research work in business affairs and practices.

(viii) **Employees :**

They are interested to know the growth of profit. As a result of which they can demand better remuneration and congenial working environment.

(ix) **Government and their agencies :**

Government and their agencies need financial information to regulate the activities of the enterprises/ industries and determine taxation policy. They suggest measures to formulate policies and and regulations.

(x) **Stock exchange :**

The stock exchange members take interest in financial statements for the purpose of analysis because they provide useful financial information about companies. Thus, we find that different parties have interest in financial statements for different reasons.

Types of Analysis and Interpretations

The analysis and interpretation of financial statements can be classified into different categories depending upon :

I. The Materials Used

II. Modus Operandi (Methods of Operations to be followed)

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I. On the Basis of Materials Used

On the basis of materials used the analysis and interpretations of financial statements may be Classified into (a) External Analysis and (b) Internal Analysis.

(a**) External Analysis**: This analysis meant for the outsiders of the business firm. Outsiders may be investors, creditors, suppliers, government agencies, shareholders etc. These external people have to rely only on these published financial statements for important decision making. This analysis serves only a limited purpose due to non-availability of detailed information.

(b) **Internal Analysis**: Internal analysis performed by the persons who are internal to the organization. These internal people who have access to the books of accounts and other informations related to the business. Such analysis can be done for the purpose of assisting managerial personnel to take corrective action and appropriate decisions.

II. On the basis of Modus Operandi

On the basis of Modus operandi, the analysis and interpretation of financial statements may be classified into: (a) Horizontal Analysis and (b) Vertical Analysis.

(a) **Horizontal Analysis**: Horizontal analysis is also termed as Dynamic Analysis. Under this type of analysis, comparison of the trend of each item in the financial statements over the number of years are reviewed or analyzed. This type of comparison helps to identify the trend in various indicators of performance. In this type of analysis, current year figures are compared with base year for figures are presented horizontally over a number of columns.

(b) **Vertical Analysis**: Vertical Analysis is also termed as Static Analysis. Under this type of analysis, a number of ratios used for measuring the meaningful quantitative relationship between the items of financial statements during the particular period. This type of analysis is useful in comparing the performance, efficiency and profitability of several companies in the same group or divisions in the same company.

TOOLS OF FINANCIAL STATEMENT ANALYSIS

The following are the important tools which are commonly used for analysing and interpreting financial statements :

1. Comparative financial statements
2. Common size statements
3. Trend analysis
4. Ratio analysis
5. Funds flow analysis
6. Cash flow analysis

1. Comparative Balance Sheet

The comparative balance sheet shows the different assets and liabilities of the firm on different dates to make comparison of balances from one date to another. The comparative

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balance sheet has two columns for the data of original balance sheets. A third column is used to show change (increase/decrease) in figures. The fourth column may be added for giving percentages of increase or decrease. While interpreting comparative Balance sheet the interpreter is expected to study the following aspects :

(i) Current financial position and Liquidity position
(ii) Long-term financial position
(iii) Profitability of the concern

(i) **Current financial position and Liquidity position**

For studying current financial position or liquidity position of a concern one should examine the working capital in both the years. Working capital is the excess of current assets over current liabilities.

(ii) Long-term financial position

For studying the long-term financial position of the concern, one should examine the changes in fixed assets, long-term liabilities and capital.

(iii) Profitability of the concern

The next aspect to be studied in a comparative balance sheet is the profitability of the concern. The study of increase or decrease in profit will help the interpreter to observe whether the profitability has improved or not.

After studying various assets and liabilities, an opinion should be formed about the financial position of the concern.

2. COMMON SIZE STATEMENTS

The CSS represents the relationship of different items of a financial statement with some Common item by expressing each item as a percentage of the Common item. In Common size Balance Sheet, each item of the Balance Sheet is stated as a percentage of the total of the Balance Sheet. Similarly in Common size Income Statement, each item is stated as percentage of the Net Sales. The percentages for different items are computed by dividing the absolute amount of that item by the Common base (i.e. the Balance Sheet Total or the Net Sales as the case may be) and

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then multiplying by 100. The percentage so calculated can be easily compared with the corresponding percentages in some other period. Thus, the CSS is useful not only in intra-firm comparisons over a series of different year but also in making inter-firm comparisons for the same year or for several years.

3. **TREND PERCENTAGE ANALYSIS (TPA)**

The TPA is a technique of studying several financial statements over a series of years. In TPA, the trend percentages are calculated for each item by taking the figure of that item for some base year as 100. So, the trend percentage is the percentage relationship, which each item of different years bears to the same item in the base year. Any year may be taken as the base year. Any year may be taken as the base year, but generally the starting/initial year is taken s the base year. So, each item for base year is taken as 100 and then the same item for other years is expressed as a percentage of the base year.

4. **RATIO ANALYSIS (RA)**

The RA has emerged as the principal technique of the FSA. A ratio is a relationship expressed in mathematical terms between two individual or groups of figures connected with each other in some logical manner. The RA is based on the premise that a single accounting figure by itself may not communicate any meaningful information but when expressed as a relative to some other figure, it may definitely give some significant information. The relationship between two or more accounting figures/groups is called a financial ratio. A financial ratio helps to summarize a large mass of financial data into a concise form and to make meaningful interpretations and conclusions about the performance and positions of a firm.

5. **FUNDS FLOW STATEMENT**

Funds Flow Statement is a statement, which indicates various means by which the funds have been obtained during a certain period and the ways to which these funds have been used during that period.

Funds Flow Statement is a statement either prospective or retrospective, setting out the sources and applications of the fund of an enterprise. The purpose of the statement is to indicate clearly the requirement of funds and how they are proposed to be raised and the efficient utilization and application of the same.

6. **CASH FLOW STATEMENT**

Cash Flow Statement is a statement that describes the inflow(sources) and outflow (applications) of cash and cash equivalent in an enterprise during a specified period of time. Such a statement enumerates net effect of the various business transactions on cash and its equivalent and takes into account receipts and disbursement of cash. Cash flow statement summaries the causes of changes in cash position of a business enterprise between dates of two balance sheets.

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RATIO ANALYSIS

MEANING

The relationship between two figures expressed mathematically is called a 'Ratio'. It is a numerical relationship between two numbers which are related in some manner. Ratio analysis is a technique of analysis and interpretation of financial statements. It is the process of determination and interpretation of various ratios for helping in decision making. Ratio analysis involves three steps.

a) Calculation of appropriate ratios from the financial statements.
b) Comparison of the ratios with standards or with ratios of the past period. Comparison can also be made with the ratios of other firms.
c) Interpretation of ratios.

Significance and Uses

Ratio analysis is a powerful tool of financial analysis. It is used as a device to analyses and interprets the financial health of a firm. Analysis of financial statements with the aid of ratios helps the management in decision making and control.

The use of ratio analysis is not confined to financial managers only. Different parties are interested in knowing the financial position of a firm for different purposes. Ratio analysis is used by creditors, banks, financial institutions, investors and shareholders. It helps them in making decisions regarding the granting of credit and making investments in the firm. Thus, ratio analysis is of immense use and has wide application.

CLASSIFICATION OF RATIOS

Accounting ratios can be classified in a number of ways. Important among them are stated below:

1. Classification according to statements

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a) **Profit and Loss account ratios:** Ratios calculated on the basis of the items of the profit and loss account only e.g. gross profit ration, expenses ratio, net profit ratio etc.,
b) **Balance Sheet ratios:** Ratios calculated on the basis of the figures of the balance sheet only e.g. current ratio, quick ratio proprietary ratio etc.
c) **Composite ratios:** Ratios based on figures of profit loss account as well as the balance sheet e.g. debtors and creditors turnover ratio, return on capital employed etc.,

II. Classification according to functions

a) **Solvency ratios:** Short-term and Long-term solvency ratios. e.g., Current Ratio, Debt-Equity Ratio.
b) **Profitability ratios:** E.g. Gross profit ratio, Net Profit ratio, Operating profit ratio, Return on capital employed.
c) **Turnover or Activity ratios:** e.g. Stock turnover ratio, Debtors turnover ratio, Creditors turnover ratio.
d) **Capital structure ratio:** e.g. Capital gearing ratio.

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LIMITATION OF RATIOS

Ratio analysis suffers from certain limitations. They are discussed below:

1. Inadequacy of Standards

Ratios are useful only if they are compared with some standards. But, adequate standards like industry averages are not easily available.

2. Limitation of Financial Statements

Ratios are based only on the information recorded in the financial statements. Financial statements suffer from a number of limitations. Hence, the ratios derived from them are also subjective to those limitations.

3. Ratios Alone are not adequate

Ratios are only indicators. They cannot be taken as final regarding good or bad financial position of the firm.

4. Difficulty in Comparison

In actual practice, it is difficult to have similar companies for comparison. Even if similar companies are available, their accounting periods may differ. This makes inter-firm comparison difficult.

5. Problem of Price Level Changes

Ratio analysis does not take into account the effects of changes in price level. Because of this, interpretation of ratios becomes invalid.

6. Window Dressing

Financial statements can easily be window dressed to present a better picture of the financial and profitability positions.

7. No Fixed Standards

No fixed standards can be laid down.

8. No Indicators of Future

Ratios are generally calculated from past financial statements. Hence, they are no indicators of the future.

SHORT TERM FINANCIAL RATIOS

I. Liquidity Ratios:

For the purpose of financial analysis, ratios are classified into liquidity ratios, solvency ratios, profitability ratios, activity ratios and capital structure ratios.

1. **Current Ratio:** Current Ratio is the relationship between current assets and current liabilities.

$$\textbf{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

a) **Current Assets: Stock, Debtors, Cash in hand & bank, Bills receivable, Prepaid Expanses.**

b) **Current Liabilities: Creditors Bills Payable Bank Overdraft Proposed dividend**

2. **Quick Ratio or Liquid Ratio**

Quick Ratio is also called Acid-test ratio because it is the acid test of a concern's financial soundness. It is the relationship between quick assets and quick liabilities. Quick assets are those assets which are readily converted into cash. They include cash and bank balances, bill receivable, debtors, short-term investments. Quick liabilities include creditors, bills payable, outstanding expenses.

$$\textbf{Quick Ratio} = \frac{\textbf{Quick assets}}{\textbf{Quick liabilities}}$$

Quick assets = Current assets – (Stock + Prepaid expenses)

Quick liabilities = Current liabilities – Bank overdraft

A quick ratio of 1: 1 is considered satisfactory. The quick ratio supplements current ratio.

LONG TERM FINANCIAL RATIOS

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I. Solvency Ratios

Solvency ratios assess the long-term financial condition of the firm. The following are the widely used solvency ratios

1. Debt-Equity ratio

The debt-equity ratio establishes the relationship between shareholders' funds and outsiders' funds. Outsiders' funds include all long-term and short-term debts. Shareholders' funds consist of preference share capital, equity share capital and reserves and surplus.

$$\textbf{Debt – Equity ratio} = \frac{\textbf{Debt}}{\textbf{Equity}} \quad \textbf{(or)} \quad \frac{\textbf{Outsiders' funds}}{\textbf{Shareholders' funds}}$$

$$\textbf{Debt – Equity ratio} = \frac{\textbf{Long-term Debt}}{\textbf{Shareholders' funds}}$$

PROPRIETORY RATIO

Proprietor Ratio is the relationship between proprietors' funds and total tangible assets.

$$\textbf{Proprietor ratio} = \frac{\textbf{Shareholders' funds}}{\textbf{Total tangible assets}}$$

PROFITABILITY RATIOS

Profitability ratios measure the profitability of a firm's business operations. These ratios may be related to sales (e.g. Gross profit ratio) or investments (e.g., Return on assets or Return capital employed).

1. Gross Profit Ratio

This ratio expenses the relationship between gross profit and net sales.

$$\textbf{Gross Profit Ratio} = \frac{\textbf{Gross Profit}}{\textbf{Sales}}$$

2. Net Profit Ratio

This ratio measures the relationship between net profit and net sales.

$$\textbf{Net profit Ratio} = \frac{\textbf{Net Profit}}{\textbf{Sales}}$$

3. Operating Ratio

Operating ratio matches cost of goods sold and other operating expenses with sales.

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$$\textbf{Operating Ratio} = \frac{\textbf{Cost of goods sold + operating expenses}}{\textbf{Sales}}$$

4. Return on Capital Employed

Return on capital employed establishes the relationship between profits and the capital employed. It is most widely used to measure the overall profitability and efficiency of the business.

$$\textbf{Return on capital employed} = \frac{\textbf{Net Profit + Interest + Taxes}}{\textbf{Average Capital Employed (Or) Capital Employed}} \times 100$$

Capital employed = Fixed Assets + Current assets – Current Liabilities

(Or)

Shareholders' Funds + Long term liabilities

TURNOVER RATIOS (or) EFFICIENCY RATIO

An activity ratio measures the efficiency of asset management. The efficiency in (asset utilization) the use of assets would be reflected by the speed with which they are converted into sales. Activity ratios indicate the relationship between sales and various assets of the firm.

1. Stock (or Inventory) Turnover Ratio

This ratio indicates the number of times stock is turned over (or re-placed) during a year. A high ratio indicates quick movement of stock and vice versa.

$$\textbf{Stock turnover ratio} = \frac{\textbf{Cost of goods sold}}{\textbf{Average Stock}}$$

2. Debtors turnover Ratio

This ratio shows, on an average, the number of times debtors are turned over during a year. A higher ratio indicates efficiency in asset management and vice versa.

Credit Sales

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$$\textbf{Debtors turnover Ratio} = \frac{}{\textbf{Debtors}}$$

Average Collection Period

This ratio indicates the speed with which debtors/accounts receivable are collected. It shows the number of days taken to collect money from debtors.

$$\textbf{Average collection Period} = \frac{\textbf{Debtors + Bills Receivable}}{\textbf{Credit Sales}}$$

3. Creditors turnover ratio

This ratio shows, on an average the number of time creditors are turned over during a year. A higher ratio indicates quick settlement of dues and a lower ratio reflects liberal credit terms granted by suppliers.

$$\textbf{Creditors turnover ratio} = \frac{\textbf{Credit Purchases}}{\textbf{Creditors}}$$

Average Payment Period: It refers to the number of days taken by the firm to pay its creditors.

$$\textbf{Average collection Period} = \frac{\textbf{Creditors + Bills Payable}}{\textbf{Credit Purchases}} \textbf{ x No. of working days in a year}$$

Generally, lower the ratio, the better is the liquidity position of the firm.

4. Fixed Assets Turnover Ratio

Fixed assets turnover ratio explains, the relationship between equity shareholders' funds on he one hand and preference share capital and fixed interest bearing loan on the other.

$$\textbf{Fixed assets turnover ratio} = \frac{\textbf{Sales}}{\textbf{Net Fixed assets}}$$

CAPITAL STRUCTURE RATIOS

Capital Gearing Ratio: The Ratio explains the relationship between equity shareholders' funds on the one hand and preference share capital and fixed interest bearing loan on the other.

$$\textbf{Capital gearing ratio} = \frac{\textbf{Preference share capital + Fixed interest securities}}{}$$

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Equity shareholders' funds

UNIT 2

Meaning of Fund Flow Statement:

The funds flow statement is a report on the movement of funds or working capital. It explains how working capital is raised and used during an accounting period.

Definition:

"A statement of sources and application of funds is a technical device designed to analyses the changes in the financial condition of a business enterprise between two dates."

Objectives:

The main objectives of funds flow statements are:

1) To show how the resources have been obtained and used.
2) To indicate the results of current financial management.
3) To throw light upon the most important changes that has taken place during a specific period.
4) To show how the general expansion of the business has been financed.
5) To indicate the relationship between profits from operations distribution of dividend and raising of new capital or term loans.
6) To have an assessment of the working capital position of the concern.

Limitations of fund flow statements:

The limitation of funds flow statements are listed below,

1) Funds flow statements is not a substitute for an income statement or balance sheet. It provides only some additional information regarding changes in working capital.
2) Changes in cash are more important and relevant for financial management then the working capital.
3) It is not an original statement. It is only a rearrangement of data given in financial statements.
4) Funds flow statement is essentially historical in nature. A projected funds flow statement, on the basis of it cannot be prepared with much accuracy.
5) It cannot reveal continuous changes.

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The procedure for the preparation of funds flow statements:

Funds flow statements is usually prepared for one year on the basis of balance sheets and additional information. Preparation of funds flow statements involves the following steps.

1) **Schedule of changes of working capital:**

Working capital is the difference between current assets and current liabilities. The schedule of changes in working capital is prepared to find out the increase or decrease in working capital during the year.

Increase in working capital will appear on the "application" side of fund flow statement. Decrease in working capital will appear on the "sources" side of the fund flow statement.

Schedule of changes of working capital

Particulars	**Last year Rs**	**Current year Rs**	**Increase Rs**	**Decrease Rs**
Current Assets:				
Stock	****	****	****	****
Debtors	****	****	****	****
Cash in hand & bank	****	****	****	****
Bills receivable	****	****	****	****
Prepaid Expanses	****	****	****	****
	*******	*******		
Less Current Liabilities:				
Creditors	****	****	****	****
Bills Payable	****	****	****	****
Bank Overdraft	****	****	****	****
Proposed dividend	****	****	****	****
Provision for Taxation	****	****	****	****
Working Capital	*******	*******	*******	*******
Increase (or) Decrease in Working Capital	*****	*****	*****	*****
Total	******	******	******	******

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Preparation of Adjusted Profit and Loss Account:

The adjusted profits and loss account is prepared to ascertain funds from operation. The regular profit and loss account shows only the net profit or loss. To ascertain the funds generated by operation the adjusted profit & loss account is prepared by taking into account only the non – fund and non – operating items. 'Non – funds items refer to expanses and income which do not involves any changes in working capital (e.g, deprecations. Transfer to general reserve, writing back of provision for tax etc.). Non – Operating items refer to expenses and income which are not directly to the business

operations of the company, (E.g., dividend received, refund of tax, profit/loss on sale of assets etc.). The balancing figure in the adjusted profit and loss account is either funds from operation or funds lost in operations.

Adjusted Profit & Loss Account

Debit **Credit**

Particulars	Rs	Particulars	Rs
To Provision for depreciation	****	By Balance b/d	****
To Loss on sale of Assets	****	By Profit on sale of assets	****
To Discount	****	By Dividend received	****
To Good will	****	By Refund of tax	****
To Balance c/d	****	By Funds from Operation (balance figure)	****
	******		******

1) **Preparation of Funds Flow Statement:**

The above three steps are incorporated in the preparation of funds flow statements. Sources of funds and decrease in the working capital are entered on the sources side. Application or uses of funds and increase in working capital are entered on the application side. This completes the preparation of funds flow statement.

Funds Flow Statements

Sources of funds	Rs	Application of Funds	Rs
Issue of Shares and depenture	****	Redemption of preference shares and depenture	****
Raising of long term loans	****	Repayments of loans	****
Income from investments	****	Purchase of long term investments	****
Sale of fixed assets and long term investments	****	Purchase of fixed assets	****

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Funds from operations	****	Payment of taxes and dividends Drawings(in case of proprietary or partnership business) Loss of cash by embezzlement Funds lost in operations	**** **** **** ****
	******		******

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Meaning of Cash flow statements:

A statement prepared from the historical data (i.e., income statements and balance sheet) showing sources and uses of cash is called cash flow statements. It reveals the inflow and outflow of cash during the particular period. Cash flow statement can be prepared for a year, half year, quarter or for any other duration. The term cash is used to refer bank balance also.

Objectives:

1) To show the causes of changes in cash balance between two balance sheet dates.
2) To indicate the factors contributing to the reduction of cash balance in spite of increase in profits and vice versa.

Significance and uses of cash flow statement:

Cash flow statements are of vital significance to the financial management. Its chief advantages are.

1) The cash flow statements explain the reasons for low cash balance in spite of huge profits or large cash balance in spite of low profits.
2) It helps in short – term financial decisions relating to liquidity.
3) It shows the major sources and uses of cash. The management with the aid of projected cash flow statement can know
   a) How much cash will be needed
   b) From which sources it can be obtained
   c) How much can be generated internally
   d) How much could be obtained from outside
4) It helps the management in planning the repayment of loans, replacement of assets, credit arrangement etc. it is also significance for capital budgeting decisions.
5) On the basis of past years cash flow statements projections can be made for the future. The projected cash flow statement helps in planning for the investment of surplus or meeting the deficit.
6) A comparison of actual cash flow statement with the projected cash flow statement helps in understanding the variations and control of cash expenditure.

Difference between cash flow statement and funds flow statement

The cash flow statement differs from funds flow statement in the following ways:

1) In a cash flow statement, only cash receipts and payments are recorded. But in a funds flow statement increase or decrease in working capital is recorded.
2) The cash flow statement indicates the causes for changes in cash position. On the other hand, a funds flow statement shows the cause of changes in working capital.
3) A cash flow statement is appropriate for short planning while funds flow statement is appropriate for long range planning.
4) Whenever there is inflow of cash there will definitely be inflow of funds. But it is not vice versa. Inflow of funds does not necessarily mean inflow of cash.
5) Cash flow statement starts with opening cash balance and closes with the closing cash balance. But there are no opening and closing balance in funds flow statement.

UNIT 3

MARGINAL COSTING

Meaning:

The term Marginal Cost refers to the amount at any given volume of output by which the aggregate costs are charged if the volume of output is changed by one unit. Accordingly, it means that the added or additional cost of an extra unit of output.

Definition:

Marginal cost may also be defined as the "cost of producing one additional unit of product." Thus, the concept marginal cost indicates wherever there is a change in the volume of output; certainly there will be some change in the total cost. It is concerned with the changes in variable costs. Fixed cost is treated as a period cost and is transferred to Profit and Loss Account.

According to J. Batty, Marginal costing is "a technique of cost accounting pays special attention to the behaviour of costs with changes in the volume of output." This definition lays emphasis on the ascertainment of marginal costs and also the effect of changes in volume or type of output on the company's profit.

FEATURES OF MARGINAL COSTING:

a. All elements of costs are classified into fixed and variable costs.
b. Marginal costing is a technique of cost control and decision making.
c. Variable costs are charged as the cost of production.
d. Valuation of stock of work in progress and finished goods is done on the basis of variable costs.
e. Profit is calculated by deducting the fixed cost from the contribution, i.e., excess of selling price over marginal cost of sales.
f. Profitability of various levels of activity is determined by cost volume profit analysis.

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Advantages of Marginal Costing

The following are the important decision making areas where marginal costing technique is used :

i. Pricing decisions in special circumstances
    1. Pricing in periods of recession;
    2. Use of differential selling prices.

2. Acceptance of offer and submission of tenders.
    a. Make or buy decisions.
    b. Shutdown or continue decisions or alternative use of production facilities.
    c. Retain or replace a machine.
    d. Decisions as to whether to sell in the export market or in the home market.
    e. Change Vs status quo.
    f. Whether to expand or contract.
    g. Product mix decisions like for example :
        1. Selection of optimal product mix;
        2. Product substitution;
        3. Product discontinuance.
    h. Break-Even Analysis

Limitations of Marginal Costing

a. It may be very difficult to segregation of all costs into fixed and variable costs.
b. Marginal Costing technique cannot be suitable for all type of industries. For example, it is difficult to apply in ship-building, contract industries etc.
c. The elimination of fixed overheads leads to difficulty in determination of selling price.
d. It assumes that the fixed costs are controllable, but in the long run all costs are variable.
e. Marginal Costing does not provide any standard for the evaluation of performance which is provided by standard costing and budgetary control.
f. With the development of advanced technology fixed expenses are proportionally increased. Therefore, the exclusion of fixed cost is less effective.
g. Under marginal costing elimination of fixed costs results in the under valuation of stock of work in progress and finished goods. It will reflect in true profit.
h. Marginal Costing focuses its attention on sales aspect. Accordingly, contribution and profits are determined on the basis of sales volume. It does not consider other functional aspects.
i. Under Marginal Costing semi variable and semi fixed costs cannot be segregated accurately.

Distinction between absorption costing and marginal costing

Points of Distinction	Absorption Costing	Marginal Costing
1. Charging of costs	Fixed costs form part of total costs of production	Variable costs alone form part ofcost of production, and sales

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	and distribution.	whereas fixed costs are charged against contribution for determination of profit.
2. Variation in profits	When there is no sales the entire stock is carried forward and there is no trading profit or loss.	If there is no sales, the fixed overhead will be treated as loss in the absence of contribution. It is not carried forward as part of stockvalue.
3. Valuation of stocks	Stocks and work-inprogress are valued at both fixed and variable costs i.e., total cost	Stocks are valued at variable cost only.
4. Purpose	Absorption costing is more suitable for longterm decision making and for pricing policy over long-term.	Marginal costing is more useful for short-term managerial decision making.
5. Emphasis	Absorption costing lays emphasis on production	Marginal costing emphasizes selling and pricing aspects

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COST VOLUME PROFIT ANALYSIS

Cost Volume Profit Analysis (C V P) is a systematic method of examining the relationship between changes in the volume of output and changes in total sales revenue, expenses (costs) and net profit. In other words. it is the analysis of the relationship existing amongst costs, sales revenues, output and the resultant profit.

To know the cost, volume and profit relationship, a study of the following is essential :

- Marginal Cost Formula
- Break-Even Analysis
- Profit Volume Ratio (or) PN Ratio
- Profit Graph
- Key Factors and
- Sales Mix

Objectives of Cost Volume Profit Analysis

The following are the important objectives of cost volume profit analysis:

- Cost volume is a powerful tool for decision making.
- It makes use of the principles of Marginal Costing.
- It enables the management to establish what will happen to the financial results if a specified level of activity or volume fluctuates.
- It helps in the determination of break-even point and the level of output required to earn a desired profit

- The PN ratio serves as a measure of efficiency of each product, factory, sales area etc. and thus helps the management to choose a most profitable line of business.
- It helps us to forecast the level of sales required to maintain a given amount of profit at different levels of prices

Marginal Cost Equation

The Following are the main important equations of Marginal Cost :

Sales = Variable Cost + Fixed Expenses ± Profit *I* Loss
(or)
Sales - Variable Cost = Fixed Cost ± Profit or Loss
(or)
Sales - Variable Cost = Contribution
Contribution = Fixed Cost + Profit

The above equation brings the fact that in order to earn profit the contribution must be more than fixed expenses. To avoid any loss, the contribution must be equal to fixed cost.

Contribution

The term Contribution refers to the difference between Sales and Marginal Cost of Sales. It also termed as "Gross Margin." Contribution enables to meet fixed costs and profit. Thus, contribution will first covered fixed cost and then the balance amount is added to Net profit. Contribution can be represented as

Contribution = Sales - Marginal Cost
Contribution = Sales - Variable Cost
Contribution = Fixed Expenses + Profit
Contribution - Fixed Expenses = Profit
Sales - Variable Cost = Fixed Cost + Profit

P/V (Profit Volume) Ratio

This is the ratio of contribution to sales. It is an important ratio analysis the relationship between sales and contribution. A high P/V ratio indicates high profitability and low P/V ratio indicates low profitability. This ratio helps in comparison of profitability of various products.

Since high P/V ratio indicates high profits, the objective of every organization should be to improve or increase the P/V ratio

P/V Ratio can be improved by:

(1) Decreasing the variable cost by efficiently utilizing material, machines and men.
(2) Selecting most profitable product mix for production and sales.

Break even Analysis and Break even Point

Break even analysis is a method of studying relationship between revenue and costs in relation to sales volume of a business enterprise and determination of volume of sales at which total costs are equal to revenue. At the break even point a business man neither earns

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any profit nor incurs any loss. Break even point is also called “No profit, no loss point” or “Zero profit & zero loss point”.

Margin of Safety

Break even analysis includes the concept of margin of safety. Margin of safety is the difference between actual sales and break even sales. Margin of safety is calculated in rupees, units or even in percentage form. Margin of safety indicates the value/volume of sales which directly contribute of profit, as fixed costs have already been recovered at break even point

(*i*) **Break Even Point** $= \dfrac{\text{Fixed Costs (i.e. FC)}}{\text{P/V Ratio}}$

(*ii*) **Value of sales to earn a desired amount of profit :**

$$\text{Sales} = \frac{\text{Fixed Costs + Desired Profit}}{\text{P/V Ratio}}$$

(*iii*) **Variable Costs = Sales (1 – P/V Ratio)**

(*iv*) **Profit = (Sales × P/V Ratio) – Fixed Cost**

(*v*) **Fixed Cost = (Sales × P/V Ratio) – Profit**

(*vi*) **Margin of Safety** $= \dfrac{\text{Profit}}{\text{P/V Ratio}}$

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UNIT 4
BUDGETARY CONTROL

Meaning and Definition

Budget: A budget is the monetary and/or quantitative expression of business plans and policies to be pursued in the future period of time. Budgeting is preparing budgets and other procedures for planning, coordination and control of business enterprise.

I.C.M.A. defines a budget as “A financial and /or quantitative statement, prepared prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining a given objective.”

As per the above definition, the essential features of a budget are:

(a) A budget is a financial statement but it can be a statement of quantities also with or without monetary data:

(b) Budget is prepared for a particular period and it is prepared in advance.

(c) Budget is a detailed plan of the policy to be pursed during the period for which the budget is prepared.

(d) The function of the budget is to attain a specific objective.

Budgetary Control

Budgetary control is the process of preparation of budgets for various activities and comparing the budgeted figures for arriving at deviations if any, which are to be eliminated in future. Thus budget is a means and budgetary control is the end result. Budgetary control is a continuous process, which helps in planning and coordination. It also provides a method of control.

Definition

According to Brown and Howard" Budgetary control is a system of coordinating costs, which includes the preparation of budgets. Coordinating the work of departments and establishing responsibilities, comparing the actual performance with the budgeted and acting upon results to achieve maximum profitability".

Objectives of Budgetary Control

Budgetary control is inevitable for policy formulation, planning, control and coordination. The essence of budgeting is to plan and control. Following are the main objectives of budgetary control.

1. Planning: Budgeting ensures effective planning by setting up of budgets.
2. Coordination: Budgets are helpful in coordination of business activities.
3. Efficiency and Economy: Effective budgetary control results in cost control and cost reduction.
4. Increase in Profitability: Costs are controlled with help of budgets and profits targeted are achieved.
5. Anticipation of future capital expenditure: Estimated increases in sales necessitating higher production capacity provides advance warning for the possible capital expenditure in near future.
6. Control: Controlling function is made to be effective as the control is centralized while budgets are prepared and implemented.
7. Deviations: Ascertainments of deviations is essential to fix responsibility and correct the deviations as far as possible.

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Advantages of Budgetary Control

1. **Maximisation of Profits:**

Budgetary control aims at increasing the overall profits of the organization. This is achieved through planning, coordination and control of various activities in a programmed manner.

2. **Effective Coordination:**

Performance and working of various activities is effectively coordinated through budgetary control. Budgets of the various functions are interlinked and dependent. Effective implementation of budgets depends on cooperation of concerned personnel of various departments.

3. **Evaluation of Executive Performance:**

Goals are set for each department. Actual performance is compared with standards and deviations are reported to top management for action against unfavorable deviations.

4. **Clear-cut Goals and Targets:**

Through the process of budgeting the goals of different departments are set in advance in consultation with those in charge of them.

5. **Economy in Operations:**

Expenses are properly planned and financial resources are put to optimum use. The benefits are extended to the industry and then to national economy.

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Limitations of Budgetary Control

1. **Prediction of uncertain future:**

Budgeting is a process of forecasting and estimation. Forecasting may not be accurate. Therefore budgets based on inaccurate forecasts and estimates may not be accurate and effective.

2. **Changes of Conditions:**

Budgets are prepared on the basis of certain prevailing conditions. If the conditions change budgets are also to be revised.

3. **Complacence:**

   General tendency of employees is to achieve the targets as budgeting fixes the targets. Some of the employees who are highly skillful may also be satisfied in performing up to the goals set without showing full potential, which will be a loss to the enterprise as well as the employee in terms of productivity.

4. **Difficulty in Coordination:**

   Effective implementation of budgetary control depends upon proper coordination among various departments as the performance of a department depends on the work of other departments and vice versa.

5. **Conflict among Different Departments:**

   Budgetary control sets targets for different departments individually. This will make the departmental heads to be selfish to get maximum funds and think in terms of achieving their own set targets, thereby raising conflict among different departments.

Essentials of Successful Budgetary Control

1. **Top Management Support:**

   The budgetary control system should have continuous support of top management, which can ensure it's all round acceptances.

2. **Clearly defined Organizational Structure:**

   The authority and responsibilities are to be properly defined to pinpoint the responsibility of specific individuals in key positions.

3. **Efficient Accounting System:**

   The accounting system should provide the required information in time.

4. **Reporting of Deviations:**

   Efficient system has to be devised to reduce the differences between the budgets and actual performance.

5. **Motivation:**

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Staff is to be appraised of the budgets and benefits they are going to derive directly and indirectly.

6. Realistic Targets:

The targets set should be realistic so that they are achievable and budgets should not frustrate the workers by fixing unrealistic targets.

7. Participation of all Departments Concerned:

Budgets are to be set for all the departments so that their participation in implementation will be effective.

8. Flexibility:

Budgets are prepared on the basis of certain conditions. If there is change in conditions budgets also should be adjusted to accommodate the changes.

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Types of Budgets

(1) Sales Budget:

In the budgeting process, a sale is a starting point, as sales are the key factor in many cases.

W.W.Bigg Writes, "This is probably most important budget, as it is usually the most difficult of forecast to attain".

The sales budget is generally prepared by the sales manager of the concern. This budget is prepared by taking general factors into account like policies relating to the prices, economic situation, intensity of competition, substitutes for the products, discounts and other terms and offers made. The sales budget includes:

a) Sales quantities
b) Territory-wise or area –wise analysis
c) Cost of sales promotion
d) Methods adopted for increasing sales.

(2) Production Budget:

This budget is based on sales budget, unless production itself is the key-factor. It shows the budgeted quantity of output to be produced during a specific period. It has two

parts, one showing the output for the period and the other showing production costs. The following key elements are considered while preparing the production budget.

(1) Production Planning
(2) Volume or Quantity of Output
(3)Quantities of Stocks:
(4) Coordination with Sales Budget

Preparation of effective production budget is helpful in

(a) Minimization of wastage, spoilage, defectives,
(b) Avoidance of overstocking,
(c) Production of required quantities at the right time as per schedule.

Cash Budget:

Cash budget is an important budget. It estimates the amount of cash receipts and payments and the balance of cash or estimates of cash showing what funds would be available at what times and whether the funds available would meet requirements. The objective of cash budget is to provide for all cash requirements in time and avoid accumulation of excess cash.

Flexible Budget:

Flexible budget is designed to change according to the level of activity.

Flexible budget has been defined by I.C.M.A. U.K. as "a budget, which, by recognizing the difference between fixed, semi fixed and variable costs, is designed to change in relation to the level of activity". Costs of various levels can be easily obtained, price fixation and estimation of profit at different levels of activity is made easy.

UNIT 5
WORKING CAPITAL

Meaning:

The term working capital is commonly used for the capital required for day-to-day working in a business concern, such as for purchasing raw material, for meeting day-to-day expenditure on salaries, wages, rents rates, advertising *etc.* But there are much disagreement among various financial authorities (Financiers, accountants, businessmen and economists) as to the exact meaning of the term working capital

Concepts of working capital

1. Gross Working Capital: It refers to the firm's investment in total current or circulating assets.

2. Net Working Capital:

The term "Net Working Capital" has been defined in two different ways:

i. It is the excess of current assets over current liabilities. This is, as a matter of fact, the most commonly accepted definition. Some people define it as only the difference between current assets and current liabilities. The former seems to be a better definition as compared to the latter.

ii. It is that portion of a firm's current assets which is financed by long-term funds.

3. Permanent Working Capital: This refers to that minimum amount of investment in all

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current assets which is required at all times to carry out minimum level of business activities. In other words, it represents the current assets required on a continuing basis over the entire year. Tandon Committee has referred to this type of working capital as "Core current assets

4. Temporary Working Capital: The amount of such working capital keeps on fluctuating from time to time on the basis of business activities. In other words, it represents additional current assets required at different times during the operating year. For example, extra inventory has to be maintained to support sales during peak sales period. Similarly, receivable also increase and must be financed during period of high sales. On the other hand investment in inventories, receivables, *etc.*, will decrease in periods of depression.

5. Negative Working Capital: This situation occurs when the current liabilities exceed the current assets. It is an indication of crisis to the firm.

DETERMINANTS OF WORKING CAPITAL :

The factors influencing the working capital decisions of a firm may be classified as two groups,such as internal factors and external factors. The internal factors includes, nature of business size of business, firm's product policy, credit policy, dividend policy, and access to money and capital markets, growth and expansion of business *etc.* The external factors include business fluctuations, changes in the technology, infrastructural facilities, import policy and the taxation policy *etc.* These factors are discussed in brief in the following lines.

I. Internal Factors

1. Nature and size of the business

The working capital requirements of a firm are basically influenced by the nature and size of the business. Size may be measured in terms of the scale of operations. A firm with larger scale of operations will need more working capital than a small firm. Similarly, the nature of the business - influence the working capital decisions. Trading and financial firms have less investment in fixed assets. But require a large sum of money to be invested in working capital. Retail stores, business units require larger amount of working capital, where as, public utilities need less working capital and more funds to invest in fixed assets.

2. Firm's production policy

The firm's production policy (manufacturing cycle) is an important factor to decide the working capital requirement of a firm. The production cycle starts with the purchase and use of raw material and completes with the production of finished goods. On the other hand production policy is uniform production policy or seasonal production policy etc., also influences the working capital decisions. Larger the manufacturing cycle and uniform production policy – larger will be the requirement of working capital. The working capital requirement will be higher with varying production schedules in accordance with the changing demand.

3. Firm's credit policy

The credit policy of a firm influences credit policy of working capital. A firm following liberal credit policy to all customers require funds. On the other hand, the firm adopting strict credit policy and grant credit facilities to few potential customers will require less amount of working capital.

4. Availability of credit

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The working capital requirements of a firm are also affected by credit terms granted by its
suppliers – *i.e.* creditors. A firm will need less working capital if liberal credit terms are available to it. Similarly, the availability of credit from banks also influences the working capital needs of the firm. A firm, which can get bank credit easily on favourable conditions will be operated with less working capital than a firm without such a facilitywith less working capital than a firm without such a facility.

5. Growth and expansion of business

Working capital requirement of a business firm tend to increase in correspondence with growth in sales volume and fixed assets. A growing firm may need funds to invest in fixed assets in order to sustain its growing production and sales. This will, in turn, increase investment in current assets to support increased scale of operations. Thus, a growing firm needs additional funds continuously.

6. Profit margin and dividend policy

The magnitude of working capital in a firm is dependent upon its profit margin and dividend policy. A high net profit margin contributes towards the working capital pool. To the extent the net profit has been earned in cash, it becomes a source of working capital. This depends upon the dividend policy of the firm. Distribution of high proportion of profits in the form of cash dividends results in a drain on cash resources and thus reduces company's working capital to that extent. The working capital position of the firm is strengthened if the management follows conservative dividend policy and *vice versa.*

7. Operating efficiency of the firm

Operating efficiency means the optimum utilisation of a firm's resources at minimum cost. If
a firm successfully controls operating cost, it will be able to improve net profit margin which, will, in turn, release greater funds for working capital purposes.

8. Co-ordinating activities in firm

The working capital requirements of a firm is depend upon the co-ordination between production and distribution activities. The greater and effective the co-ordinations, the pressure on the working capital will be minimized. In the absence of co-ordination, demand for working capital is reduced.

II. External Factors

1. Business fluctuations

Most firms experience fluctuations in demand for their products and services. These business
variations affect the working capital requirements. When there is an upward swing in the economy, sales will increase, correspondingly, the firm's investment in inventories and book debts will also increase. Under boom, additional investment in fixed assets may be made by some firms to increase their productive capacity. This act of the firm will require additional

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funds. On the other hand when, there is a decline in economy, sales will come down and consequently the conditions, the firm try to reduce their short-term borrowings. Similarly the seasonal fluctuations may also affect the requirement of working capital of a firm.

2. Changes in the technology

The technological changes and developments in the area of production can have immediate
effects on the need for working capital. If the firm wish to install a new machine in the place of old system, the new system can utilise less expensive raw materials, the inventory needs may be reduced there by working capital needs.

3. Import policy

Import policy of the Government may also effect the levels of working capital of a firm since
they have to arrange funds for importing goods at specified times.

4. Infrastructural facilities

The firms may require additional funds to maintain the levels of inventory and other current
assets, when there is good infrastructural facilities in the company like, transportation and communications.

5. Taxation policy

The tax policies of the Government will influence the working capital decisions. If the Government follow regressive taxation policy, *i.e.* imposing heavy tax burdens on business firms, they are left with very little profits for distribution and retention purpose. Consequently the firm has to borrow additional funds to meet their increased working capital needs. When there is a liberalised tax policy, the pressure on working capital requirement is minimised.

Standard Costing

Standard Costing is a concept of accounting for determination of standard for each element of costs. These predetermined costs are compared with actual costs to find out the deviations known as "Variances."Identification and analysis of causes for such variances and remedial measures should be taken in order to overcome the reasons for Variances.

Advantages of Standard Costing

The following are the important advantages of standard costing :

a. It guides the management to evaluate the production performance.
b. It helps the management in fixing standards.
c. Standard costing is useful in formulating production planning and price policies.
d. It guides as a measuring rod for determination of variances.
e. It facilitates eliminating inefficiencies by taking corrective measures.
f. It acts as an effective tool of cost control.
g. It helps the management in taking important decisions.
h. It facilitates the principle of "Management by Exception."
i. Effective cost reporting system is possible.

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Limitations of Standard Costing

Besides all the benefits derived from this system, it has a number of limitations which are given below:

a. Standard costing is expensive and a small concern may not meet the cost.
b. Due to lack of technical aspects, it is difficult to establish standards.
c. Standard costing cannot be applied in the case of a- concern where non-standardised products are produced.
d. Fixing of responsibility is difficult. Responsibility cannot be fixed in the case of uncontrollable variances.
e. Frequent revision is required while insufficient staff is incapable of operating this system.
f. Adverse psychological effects and frequent technological changes will not be suitable for standard costing system

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