**DEPARTMENT OF BUSINESS ADMINISTRATION**

**VI- SEMESTER**

**MANAGEMENT ACCOUNTING**

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**UNIT-5**

**(UNCOVERED PORTION)**

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SYLLABUS:

UNIT :5

Working capital-Types-Factors determining working capital-Estimate of working capital requirements- Standard costing – Material and labour variance only.

**CONTENTS:**

* **WORKING CAPITAL**
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* WORKING CAPITAL
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**WORKING CAPITAL**

**Capital required for a business may be classified into two types**

1, Fixed capital

2, Working capital

**FIXED CAPITAL**

Capital required to purchase the fixed assets like land, buildings, machinery, office equipments and furniture called fixed capital.

**WORKING CAPITAL**

Capital required for purchase of raw materials, and for meeting the day to day expenditure on salaries, wages, rents, advertising etc., is called working capital.

**GROSS WORKING CAPITAL**

It represents the amount of funds invested in current assets. Under the gross concept, working capital is equal to total current assets.

**NET WORKING CAPITAL**

It mentions the excess of current asset over current liabilities. The concept of net working capital is widely accepted.

**NEED FOR WORKING CAPITAL**

There are the time gap between the purchase of raw materials and production, production and sales, sales and realization of cash. Thus, the need for working capital arises due to the time gap between purchase of raw materials and realisation of cash from sales.

1. To purchase raw materials, spares and component parts.
2. To pay wages and salaries.
3. To incur day-to-day expenses.
4. To meet selling costs such as packing, advertising.
5. To provide credit facilities to customers.

**IMPORTANCE / ADVANTAGES OF WORKING CAPITAL**

1. **COTINUOUS PRODUCTION**

Adequate working capital ensures regular supply of raw materials and continuous production.

1. **SOLVENCY AND GOODWILL**

Adequate working capital enables prompt payment of creditors. This helps in creating and maintaining goodwill.

1. **EASY LOANS**

A concern having sufficient working capital enjoys high liquidity and good credit standing. Hence it can secure loans from banks and others on easy and favourable terms.

1. **CASH DISCOUNTS**

Adequate working capital enables a concern to avail cash discounts on the purchases, leading to a reduction in cost.

1. **REGULAR PAYMENT OF EXPENSES**

A company which has ample working capital can make regular payment of salaries, wages and other day to day commitments. Such prompt payment raises the morale of employee and increases their efficiency. As a result, costs are minimized and profit increases.

1. **EXPLOITATION OF MARKET CONDITIONS**

A concern with adequate working capital can exploit favourable market condition. It can by its requirements of raw material in bulk when the market price is lower. Similarly, it can hold stock of finished goods to realize better prices.

1. **ABILITY TO FACE CRISIS**

Adequate working capital enables a concern to face business crisis such as depression because during such periods there is much pressure on working capital.

1. **HIGH RETURN ON INVESTMENT**

Adequacy working capital facilitates continuous production and effective utilization of fixed assets. Because of this, the concern is able to generate more profits and ensure higher return on investments.

**FACTORS DETERMINING THE WORKING CAPITAL**

* Size of the sales is one of the important factor determine the working capital. In order to increase the sales volume the enterprise needs to maintain the current assets.
* Conversion of cash through various stages, it takes a certain period of time that is known as length of operating cycle time, longer time required more working capital.
* The requirement of working capital also varies among the nature of the business.
* The seasonal enterprises i.e, the enterprise whose operation s pick up seasonally may require more working capital.
* If inventories are large size but turnover is slow the enterprise need more working capital.
* If the production technology is capital intensive, the enterprise will have to make less payment for wages. As a result enterprise will required less working capital.

**DISADVANTAGES OF EXCESSIVE WORKING CAPITAL**

* Excessive working capital means idle funds which earn no profits for the business. Hence the business cannot earn a proper rate of return on investments.
* Due to the low rate of return on investments, the value of shares may also fall.
* Redundant working capital may lead to unnecessary purchasing and accumulation of inventories. As a result, chances of theft waste and losses will increase.
* Excessive working capital is an indication of excessive debtors and defective credit policy. Consequently, there may be delay in collection and higher incidence of bad debts.
* Excessive working capital makes management complacent. It leads to overall inefficiency in the organisation.

**DISADVANTAGES OF INADEQUATE WORKING CAPITAL**

* A concern which has inadequate working capital cannot pay its short term liabilities in time. As a result, it loses its reputation and faces tight credit terms
* It cannot buy its requirements in bulk and take advantage of cash discounts.
* The concern will experience difficulties in meeting its day to day expenses. This will lead to inefficiency, increase in cost and reduction in profits.
* It becomes difficulty to exploit favourable market condition and undertake profitable projects due to lack of working capital.
* Due to paucityworking capital, fixed asset are not effectively utilized. Thus the rate of return on investment falls.

**STANDARD COSTING**

Standard costing is an effective management tool for planning , co-ordination and control of business. It is a technique of cost control. It gives a better result when it is employed with budgetary control. It has been devised to overcome some of the limitations of historical costing.

**DEFINITION**

Standard costing is “ the preparation and use of standard costs, their comparison with actual cost and the analysis of variance to their causes and points of incidence”.

* ICMA London

Thus standard costing involves

1. Pre –determination of standard costs.
2. Recording of actual costs
3. Comparison of actual costs with standard costs to find out the difference between two.(known as variable)
4. Analysis of reasons for variance.
5. Reporting to management for taking proper action.

**VARIANCE**

**DEFINITION**

Variance is “the difference between the standard cost and the comparable actual cost incurred during a period ”.

-ICMA London

**MEANING**

Variance means difference. In standard costing , variance means the difference between the standard cost and the actual cost.

**TYPES OF VARIANCES**

* **MATERIAL**
* **MATERIAL COST VARIANCE**

It is the difference between standard materials cost and the actual materials cost. If the actual cost is less than the standard cost, the variance is favourable and vice versa. MCV arises due to the change in the price of materials or a change in the usage of materials

**MCV=(SQ\*SP)-(AQ\*AP)**

**SQ=**Standard quantity

**SP=**Standard price

**AQ=**Actual quantity

**AP=**Actual price

* **MATERIAL PRICE VARIANCE**

It is that part of material cost variance which is due to the difference between the standard price specified and the actual price paid.

**MPV=(SP-AP)AQ**

* **MATERIAL USAGE VARIANCE**

It is the difference between the standard quantity specified and the actual quantity used.

**MUV=(SQ-AQ)SP**

* **MATERIAL MIX VARIANCE**

It is the part of material usage variance which arises due to change in standard and actual composition of mix.

**MMV=(RSQ-AQ)SP**

* **MATERIAL YIELD VARIANCE**

The difference between the standard yield specified and the actual yield obtained.

**MYV=(Standard yield –Actual yield)Average standard price per unit**

* **LABOUR**
* **LABOUR COST VARIANCE**

This is the difference between the standard wages specified and the actual wages paid.

**LCV=(SH\*SR)-(AH\*AR)**

* **LABOUR RATE VARIANCE**

It is the difference between the standard rate of wage specified and the actual rate paid.

**LRV=(SR-AR)AH**

* **LABOUR EFFICIENCY VARIANCE**

It is the difference between the standard labour hours specified and the actual labour hours spent.

**LEV=(SH-AH)SR**

* **LABOUR MIX VARIANCE**

It is the difference between the standard labour grade specified and the actual labour grade utilised

**LMV=(RSH-AH)SR**

* **LABOUR YIELD VARIANCE**

It is the difference between the standard yield and the actual yield.

**LYV=(Standard yield- Actual yield)Average standard rate per unit**

* **OVERHEAD**
* **Budget variance or expenditure variance**
* **Volume variance**
* **Efficiency variance**
* **Capacity variance**
* **Calendar variance**
* **SALES**
* **Sales value variance**
* **Sales price variance**
* **Sales volume variance**
* **Sales mix variance**

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