B.C.A study

Unit -1 :Financial Accounting Overview

Meaning of Financial Accounting:

Accounting is the process of recording, classifying, summarizing, analyzing and interpreting the financial transactions of the business for the benefit of management and those parties who are interested in business such as shareholders, creditors, bankers, customers, employees, and government. Thus, it is concerned with financial reporting and decision making aspects of the business

The term 'Accounting' unless otherwise specifically stated always refers to 'Financial Accounting'. Financial Accounting is commonly carrying on in the general offices of a business. It is concerned with revenues, expenses, assets, and liabilities of a business house. Financial Accounting has the two-fold objective, viz,

- To ascertain the profitability of the business, and
- To know the financial position of the concern.

#Scope of Financial Accounting:

Financial accounting is a useful tool to manage and to external users such as shareholders, potential owners, creditors, customers, employee, and government. It provides information regarding the results of its operations and the financial status of the business.

The following are the functional areas of financial accounting:-

1. **Dealing with financial transactions:** Accounting as a process deals only with those transactions which are measurable in terms of money. Anything which cannot be expressed in monetary terms does not form part of financial accounting however significant it is.

2. **Recording of information:** Accounting is an art of recording financial transactions of a business concern. There is a limitation for human memory. It is not possible to remember all transactions of the business. Therefore, the information is recorded in a set of books called Journal and other subsidiary books and it is useful for management in its decision-making process.
3. **Classification of Data:** The recorded data is arranged in a manner so as to group the transactions of similar nature at one place so that full information of these items may be collected under different heads. This is done in the book called 'Ledger'. For example, we may have accounts called 'Salaries', 'Rent', 'Interest', Advertisement', etc. To verify the arithmetical accuracy of such accounts, the trial balance is prepared.
4. **Making Summaries:** The classified information of the trial balance is used to prepare profit and loss account and balance sheet in a manner useful to the users of accounting information. The final accounts are prepared to find out operational efficiency and financial strength of the business.
5. **Analyzing:** It is the process of establishing the relationship between the items of the profit and loss account and the balance sheet. The purpose is to identify the financial strength and weakness of the business. It also provides a basis for interpretation.
6. **Interpreting the financial information:** It is concerned with explaining the meaning and significance of the relationships established by the analysis. It should be useful to the users, so as to enable them to take correct decisions.
7. **Communicating the results:** The profitability and financial position of the business as interpreted above are communicated to the interested parties at regular intervals so as to assist them to make their own conclusions.

#Limitations of Financial Accounting:

Financial accounting is concerned with the preparation of final accounts. The business has become so complex that mere final accounts are not sufficient for meeting financial needs. Financial accounting is like a post-mortem report. At the most, it can reveal what has happened so far, but it cannot exercise any control over the past happenings.

The limitations of financial accounting are as follows:-

- It records only quantitative information.
- It records only the historical cost. The impact of future uncertainties has no place in financial accounting.
- It does not take into account price level changes.
- It provides information about the whole concern. Product-wise, process-wise, department-wise or information of any other line of activity cannot be obtained separately from the financial accounting.
- Cost figures are not known in advance. Therefore, it is not possible to fix the price in advance. It does not provide information to increase or reduce the selling price.
- As there is no technique for comparing the actual performance with that of the budgeted targets, it is not possible to evaluate the performance of the business.

- It does not tell about the optimum or otherwise of the quantum of profit made and does not provide the ways and means to increase the profits.
- In case of loss, whether loss can be reduced or converted into profit by means of cost control and cost reduction? Financial accounting does not answer this question.
- Does it not reveal which departments are performing well? Which ones are incurring losses and how much is the loss in each case?
- It does not provide the cost of products manufactured
- There are no means provided by financial accounting to reduce the wastage.
- Can the expenses be reduced which results in the reduction of product cost and if so, to what extent and how? No answer to these questions.
- It is not helpful to the management in taking strategic decisions like replacement of assets, an introduction of new products, discontinuation of an existing line, expansion of capacity, etc.
- It provides ample scope for manipulation like overvaluation or undervaluation. This possibility of manipulation reduces the reliability.
- It is technical in nature. A person not conversant with accounting has little utility of the financial accounts.

Nature of Financial Accounting:

- **Contents:** The end product of the financial accounting process is the financial statements that communicate useful information to decision-makers. The financial statements reflect a combination of recorded facts, accounting conventions and personal judgments of the preparers. There are three primary financial statements for a profit-making entity in India, viz., the Income Statement (statement of revenues, expenses, and profit), and the Balance Sheet (like the statement of assets, liabilities and owner's equity) and cash flow statement. The accounting information generated by financial accounting is quantitative, formal, structured, numerical and past-oriented material.
- **Accounting System:** The accounting system includes the various techniques and procedures used by the accountant (preparer) in measuring, describing and communicating financial data to users. Journals, ledgers and other accounting techniques used in processing financial accounting information depend upon the concept of the double-entry system. This technique includes generally accepted accounting principles (GAAP). The standard of generally accepted accounting principles includes not only broad guidelines of general application but also detailed practices and procedures.
- **Measurement Unit:** Financial accounting is primarily concerned with the measurement of economic resources and obligations and changes in them. Financial accounting measures in terms of monetary units of a society in which it operates. For example, the common denominator or yardstick used for accounting measurement is the rupee in India and dollar in the U.S.A. The assumption is that the rupee or the dollar is a useful measuring unit.
- **Users of Financial Accounting Information:** Financial accounting information is intended primarily to serve external users. Some users have the direct interest in the reported information. Examples of such users are owners, creditors, potential owners, suppliers, management, tax

authorities, employees, customers. Some users need financial accounting information to help those who have the direct interest in a business enterprise.

Users or Role of the Financial Accounting:

The most basic objective of financial accounting is the preparation of general purpose financial statements, which are financial statements meant for use by stakeholders external to the entity, who do not have any other means of getting such information, i.e. people other than the management. **These stakeholders include:**

- **Investors and Financial (https://www.ilearnlot.com/financial-analysis-meaning-objectives-and-types/)Analysis:** Investors need the information to estimate the intrinsic value of the entity and to decide whether to buy, hold or sell the entity's shares. Equity research analysts use financial statements to conduct their research on earnings expectations and price targets.
- **Working as Employee groups:** Employees and their representative groups are interested in information about the solvency and profitability of their employers to decide about their careers, assess their bargaining power and set a target wage for themselves.
- **Lead as Lenders:** Lenders are interested in information that enables them to determine whether their loans and the interest earned on them will be paid when due.
- **Suppliers and other trade creditors:** Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due and whether the demand from the company is going to increase, decrease or stay constant.
- **One of the Customers:** Customers want to know whether their supplier is going to continue as an entity, especially when they have a long-term involvement with that supplier. For example, Apple is interested in the long-term viability of Intel because Apple uses Intel processors in its computers and if Intel ceases operations at once, Apple will suffer difficulties in meeting its own demand and will lose revenue.
- **His also Governments and their agencies:** Governments and their agencies are interested in financial accounting information for a range of purposes. For example, the tax collecting authorities, such as IRS in the USA, are interested in calculating the taxable income of the tax-paying entities and finding their tax payable. Antitrust authorities, such as the Federal Trade Commission, are interested in finding out whether an entity is engaged in monopolization. The governments themselves are interested in the efficient allocation of resources and they need financial accounting information of different sectors and industries to decide on federal and state budget allocation, etc. The bureaus of statistics are interested in calculating national income, employment, and other measures.
- **Also as Public:** the public is interested in an entity's contribution to the communities in which it operates, its corporate social responsibility updates, its environmental track record, etc.

Definition of Management Accounting

Management Accounting, also known as Managerial Accounting is the accounting for managers which helps the management of the organisation to formulate policies and forecasting, planning and controlling the day to day business operations of the organisation. Both the quantitative and qualitative information are captured and analysed by the management accounting.

The functional area of management accounting is not limited to providing a financial or cost information only. Instead, it extracts the relevant and material information from financial and cost accounting to assist the management in budgeting, setting goals, decision making, etc. The accounting can be done as per the requirement of the management, i.e. weekly, monthly, quarterly, etc. and there is no format set on the basis of which it is to be reported.

Key Differences Between Financial Accounting and Management Accounting

The following points explain the major differences between financial accounting and managerial accounting:

1. Financial Accounting is the branch of accounting which keeps track of all the financial information of the entity. Management Accounting is that branch of accounting which records and reports both the financial and nonfinancial information of an entity.
2. Users of financial accounting are both the internal management of the company and the external parties while the users of the management accounting are only the internal management.
3. Financial accounting is to be publicly reported whereas the Management Accounting is for the use of the organisation and hence it is very confidential.
4. Only monetary information is contained in financial accounting. As against this, management accounting contains both monetary and non-monetary information such as the number of workers, the quantity of raw material used and sold, etc.
5. Financial Accounting is done in the prescribed format, whereas there is no prescribed format for the Management Accounting.
6. Financial Accounting focuses on providing information about the functioning of the entity's business to its users, whereas Management Accounting focuses on providing information to help them in evaluating the performance and devising plans for the future.
7. The Financial Accounting is mainly done for a specific period, which is usually one year. On the other hand, the management accounting is done as per the needs of the management say quarterly, half yearly, etc.
8. Financial accounting is a must for any company for auditing purposes. On the contrary, management accounting is voluntary, as no editing is done.
9. Financial accounting information is required to be published and audited by statutory auditors. Unlike, management accounting, which does not require information to be published and

audited, as they are for internal use only.

Accounting Concepts and Conventions

In drawing up accounting statements, whether they are external “financial accounts” or internally-focused “management accounts”, a clear objective has to be that the accounts fairly reflect the true “substance” of the business and the results of its operation.

The theory of accounting has, therefore, developed the concept of a “true and fair view”. The true and fair view is applied in ensuring and assessing whether accounts do indeed portray accurately the business’ activities.

To support the application of the “true and fair view”, accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently.

Accounting Conventions

The most commonly encountered convention is the “historical cost convention”. This requires transactions to be recorded at the price ruling at the time, and for assets to be valued at their original cost.

Under the “historical cost convention”, therefore, no account is taken of changing prices in the economy.

The other conventions you will encounter in a set of accounts can be summarised as follows:

Monetary measurement

Accountants do not account for items unless they can be quantified in monetary terms. Items that are not accounted for (unless someone is prepared to pay something for them) include things like workforce skill, morale, market leadership, brand recognition, quality of management etc.

Separate Entity

This convention seeks to ensure that private transactions and matters relating to the owners of a business are segregated from transactions that relate to the business.

Realisation

With this convention, accounts recognise transactions (and any profits arising from them) at the point of sale or transfer of legal ownership – rather than just when cash actually changes hands. For example, a company that makes a sale to a customer can recognise that sale when the transaction is legal – at the point of contract. The actual payment due from the customer may not arise until several weeks (or months) later – if the customer has been granted some credit terms.

Materiality

An important convention. As we can see from the application of accounting standards and accounting policies, the preparation of accounts involves a high degree of judgement. Where decisions are required about the appropriateness of a particular accounting judgement, the "materiality" convention suggests that this should only be an issue if the judgement is "significant" or "material" to a user of the accounts. The concept of "materiality" is an important issue for auditors of financial accounts.

Accounting Concepts

Four important accounting concepts underpin the preparation of any set of accounts:

Going Concern

Accountants assume, unless there is evidence to the contrary, that a company is not going broke. This has important implications for the valuation of assets and liabilities.

Consistency

Transactions and valuation methods are treated the same way from year to year, or period to period. Users of accounts can, therefore, make more meaningful comparisons of financial performance from year to year. Where accounting policies are changed, companies are required to disclose this fact and explain the impact of any change.

Prudence

Profits are not recognised until a sale has been completed. In addition, a cautious view is taken for future problems and costs of the business (the are "provided for" in the accounts" as soon as their is a reasonable chance that such costs will be incurred in the future.

Matching (or "Accruals")

Income should be properly "matched" with the expenses of a given accounting period.

Key Characteristics of Accounting Information

There is general agreement that, before it can be regarded as useful in satisfying the needs of various user groups, accounting information should satisfy the following criteria:

Understandability

This implies the expression, with clarity, of accounting information in such a way that it will be understandable to users – who are generally assumed to have a reasonable knowledge of business and economic activities

Relevance

This implies that, to be useful, accounting information must assist a user to form, confirm or maybe revise a view – usually in the context of making a decision (e.g. should I invest, should I lend money to this business? Should I work for this business?)

Consistency

This implies consistent treatment of similar items and application of accounting policies

Comparability

This implies the ability for users to be able to compare similar companies in the same industry group and to make comparisons of performance over time. Much of the work that goes into setting accounting standards is based around the need for comparability.

Reliability

This implies that the accounting information that is presented is truthful, accurate, complete (nothing significant missed out) and capable of being verified (e.g. by a potential investor).

Objectivity

This implies that accounting information is prepared and reported in a "neutral" way. In other words, it is not biased towards a particular user group or vested interest

Accounting Standards in India

Accounting standards codify the generally accepted accounting principles. They lay down the norms of accounting policies and practices by way of codes or guidelines to direct as to how the items appearing in the financial statements should be dealt with in the books of account and shown in the financial statements and annual reports. They present the general principles to be put to application using professional judgment.

The main purpose of accounting standards is to provide information to the user as to the basis on which the accounts have been prepared. They make the financial statements of different business units or the financial statements of the same business unit comparable. In the absence of accounting standards, comparison of different financial statements may lead to misleading conclusions. Accounting standards bring about uniformity of assumptions, rules and policies adopted in financial reporting and thus they ensure consistency and comparability in the data published by the business enterprises.

Accounting Standards in India:

Realizing that there was a need of accounting standards in India and keeping in view the international developments in the field of accounting, the Council of the Institute of Chartered Accountants of India constituted the Accounting Standards Board (ASB) in April, 1977. The Accounting Standards Board is performing the function of formulating the accounting standards. While doing so, it takes into account the applicable laws, customs, usages and business environment. It gives adequate representation to all the interested parties; the Board consists of representatives of industries, Central Board of Direct Taxes and the Comptroller and Auditor General of India.

The Institute of Chartered Accountants of India has so far issued thirty two accounting standards. They are as follows:

Accounting Standards Issued by Institute of Chartered Accountants of India (http://cdn.yourarticlelibrary.com/wp-content/uploads/2015/05/image85.png)

Accounting Standards Issued by Institute of Chartered Accountants of India (http://cdn.yourarticlelibrary.com/wp-content/uploads/2015/05/image89.png)

The IASC and the ICAI, both, consider Going Concern, Accrual and Consistency as fundamental. In other words, it will be assumed, without the fact having to be stated, that the financial statements have been drawn up on accrual basis, without any change in the accounting policies and without there being any necessity or intention to liquidate or wind up the firm or a substantial part of it.

The going concern assumption is very important; only on its basis can fixed assets be stated at cost less depreciation and their realizable value can be ignored. Also, some liabilities (such as gratuities, retrenchment compensation) arise only when the firm is liquidated. These can be ignored as long as the firm is a going concern. One can see that if the going concern assumption is not valid, the financial statements as ordinarily drawn up, will not be true at all. AS I issued by the ICAI in November, 1979 is given below. The standard has become mandatory with effect from 1.4.1991.

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Unit -2 : Basic of Accounting

Capital and Revenue Items in Accounting (6 Types)

The proper allocation of capital items and revenue items are important for the fundamental principles of correct accounting. It is not easy to give a correct rule to allocate capital items and revenue items. In order to understand them, one should know the correct principles governing the allocation between capital and revenue.

The following are the types of capital and revenue items in accounting:

(A) Capital Receipts:

Capital Receipts is the amount received in the form of additional Capital (by issuing shares) loans or by the sale proceeds of any fixed assets. Capital Receipts are shown in Balance Sheet.

(B) Revenue Receipts:

Revenue Receipts are the amount received in the ordinary course of a business. It is the incomes earned from selling merchandise, or in the form of discount, commission, interest, transfer fees etc. Income received by selling waste paper, packing cases etc. is also a revenue receipt. Revenue Receipts are shown in the Profit and Loss Account.

(C) Capital Profit:

Capital profits are earned as a result of selling some fixed assets or in connection with raising capital for the firm. For example a land purchased by a business for Rs 2, 00,000 is sold for Rs. 2, 50,000. Rs 50,000 are a profit of capital nature. Another example, suppose a company issues its shares of the face value of Rs 100 for Rs 110 each, i.e. issue of shares at premium, the premium on shares i.e. Rs 10 is capital profit. Such profits are (a) transferred to Capital Account or (b) transferred to Capital Reserve Account. This amount is utilised for meeting Capital losses. Capital Reserve appears in the Balance Sheet as a liability.

(D) Revenue Profits:

Revenue Profits are earned in the ordinary course of business. Revenue profits appear in the Profit and Loss Account. For example, profit from sale of goods, income from investments, discount received, Interest Earned etc.

(E) Capital Losses:

Capital losses occur when selling fixed assets or raising share capital. A building purchased for Rs 2, 00,000 is sold for Rs 1, 50,000. Rs 50,000 are a capital loss. Shares of the face value of Rs 100 issued at Rs 95, i.e. discount of Rs 5. The amount of discount is a capital loss.

Capital Loss is not shown in the Profit and Loss Account. They are shown in the asset side of Balance Sheet. When Capital Profit arises, Capital losses are gradually written off against them. If capital losses are huge, it is common to spread them over a number of years and a proportionate amount is charged to Profit and Loss Account every year.

Balance amount is shown in the Balance Sheet as an asset and it is written off in future years. If the loss is manageable, they are debited to Profit and Loss Account of the same year.

(F) Revenue Losses:

Revenue losses arise during the normal course of business. For instance, sale of goods, loss may incur. Such losses are debited in the Profit and Loss Account

Concept of Double Entry

Every transaction has two effects. For example, if someone transacts a purchase of a drink from a local store, he pays cash to the shopkeeper and in return, he gets a bottle of dink. This simple transaction has two effects from the perspective of both, the buyer as well as the seller. The buyer's cash balance would decrease by the amount of the cost of purchase while on the other hand he will acquire a bottle of drink. Conversely, the seller will be one drink short though his cash balance would increase by the price of the drink.

Accounting attempts to record both effects of a transaction or event on the entity's financial statements. This is the application of double entry concept. Without applying double entry concept, accounting records would only reflect a partial view of the company's affairs. Imagine if an entity purchased a machine during a year, but the accounting records do not show whether the machine was purchased for cash or on credit. Perhaps the machine was bought in exchange of another machine. Such information can only be gained from accounting records if both effects of a transaction are accounted for.

Traditionally, the two effects of an accounting entry are known as Debit (Dr) and Credit (Cr). Accounting system is based on the principal that for every Debit entry, there will always be an equal Credit entry. This is known as the Duality Principal.

Debit entries are ones that account for the following effects:

- Increase in assets
- Increase in expense
- Decrease in liability
- Decrease in equity
- Decrease in income

Credit entries are ones that account for the following effects:

- Decrease in assets
- Decrease in expense
- Increase in liability
- Increase in equity
- Increase in income

Double Entry is recorded in a manner that the Accounting Equation is always in balance.

Assets – Liabilities = Capital

Any increase in expense (Dr) will be offset by a decrease in assets (Cr) or increase in liability or equity (Cr) and vice-versa. Hence, the accounting equation will still be in equilibrium.

Purchase of machine by cash

Debit Machine *Increase in Asset*

Credit Cash *Decrease in Asset*

2. Payment of utility bills

Debit Utility Expense *Increase in Expense*

Credit Cash *Decrease in Asset*

3. Interest received on bank deposit account

Debit Cash *Increase in Asset*

Credit Finance Income *Increase in Income*

4. Receipt of bank loan principal

Debit Cash *Increase in Asset*

Credit Bank Loan *Increase in Liability*

5. Issue of ordinary shares for cash

Debit Cash *Increase in Asset*

Credit Share Capital *Increase in Equity*

What are debits and credits?

Debit and Credit are the respective sides of an account.

Debit refers to the left side of an account.

Credit refers to the right side of an account.

Explanation

In accounting, every account or statement (e.g. Accounting **(https://accounting-simplified.com/ledger-accounts.html)**ledgers, trials **(https://accounting-simplified.com/trial-balance.html)**balance, profit and losd **(https://accounting-simplified.com/financial/statements/income-statement-profit-and-loss.html)**account, balance **(https://accounting-simplified.com/financial/statements/statement-of-financial-position.html)**sheet) has 2 sides known as debit and credit.

According to the dual aspect **(https://accounting-simplified.com/financial/concepts-and-principles/duality.html)**principle, each accounting entry is recorded in 2 equal debit and credit portions. In other words, the total amount that will be recorded in the left side (debit) of accounting ledgers will always equal to the total amount recorded on the right side (credit).

B.C.A study

Unit-4:Financial management and capitalization

what is financial management?

“**Financial managemen**t is the activity concerned with planning, raising, controlling and administering of funds used in the business.”

Financial management is that area of business management devoted to a judicious use of capital and a careful selection of the source of capital in order to enable a spending unit to move in the direction of reaching the goals.

Financial management is an organic function of any business. Any organization needs finances to obtain physical resources, carry out the production activities and other business operations, pay compensation to the suppliers, etc. There are many theories around financial management:

1. Some experts believe that financial management is all about providing funds needed by a business on terms that are most favorable, keeping its objectives in mind. Therefore, this approach concerns primarily with the procurement of funds which may include instruments, institutions, and practices to raise funds. It also takes care of the legal and accounting relationship between an enterprise and its source of funds.
2. Another set of experts believe that finance is all about cash. Since all business transactions involve cash, directly or indirectly, finance is concerned with everything done by the business.
3. The third and more widely accepted point of view is that financial management includes the procurement of funds and their effective utilization. For example, in the case of a manufacturing company, financial management must ensure that funds are available for installing the production plant and machinery. Further, it must also ensure that the profits adequately compensate the costs and risks borne by the business.

nature of financial management

(i) Financial management is a specialized branch of general management, in the present-day-times. Long back, in traditional times, the finance function was coupled, either with production or with marketing; without being assigned a separate status.

(ii) Financial management is growing as a profession. Young educated persons, aspiring for a career in management, undergo specialized courses in Financial Management, offered by universities, management institutes etc.; and take up the profession of financial management.

(iii) Despite a separate status financial management, is intermingled with other aspects of management. To some extent, financial management is the responsibility of every functional manager. For example, the production manager proposing the installation of a new plant to be operated with modern technology; is also involved in a financial decision.

Likewise, the Advertising Manager thinking, in terms of launching an aggressive advertising programme, is too, considering a financial decision; and so on for other functional managers. This intermingling nature of financial management calls for efforts in producing a coordinated financial system for the whole enterprise.

(iv) Financial management is multi-disciplinary in approach. It depends on other disciplines, like Economics, Accounting etc., for a better procurement and utilisation of finances.

For example, macro-economic guides financial management as to banking and financial institutions, capital market, monetary and fiscal policies to enable the finance manager decide about the best sources of finances, under the economic conditions, the economy is passing through.

Micro-economics points out to the finance manager techniques for profit maximisation, with the limited finances at the disposal of the enterprise. Accounting, again, provides data to the finance manager for better and improved financial decision making in future.

(v) The finance manager is often called the Controller; and the financial management function is given name of controllership function; in as much as the basic guideline for the formulation and implementation of plans-throughout the enterprise-come from this quarter.

The finance manager, very often, is a highly responsible member of the Top Management Team. He performs a trinity of roles-that of a line officer over the Finance Department; a functional expert commanding subordinates throughout the enterprise in matters requiring financial discipline and a staff adviser, suggesting the best financial plans, policies and procedures to the Top Management.

In any case, however, the scope of authority of the finance manager is defined by the Top Management; in view of the role desired of him- depending on his financial expertise and the system of organizational functioning.

(vi) Despite a hue and cry about decentralisation of authority; finance is a matter to be found still centralised, even in enterprises which are so called highly decentralised. The reason for authority being centralised, in financial matters is simple; as every Tom, Dick and Harry manager cannot be allowed to play with finances, the way he/she likes. Finance is both-a crucial and limited asset-of any enterprise.

objective of financial management

In organizations, managers in an effort to minimize the costs of procuring finance and using it in the most profitable manner, take the following decisions:

Investment Decisions: Managers need to decide on the amount of investment available out of the existing finance, on a long-term and short-term basis. They are of two types:

1. Long-term investment decisions or Capital Budgeting mean committing funds for a long period of time like fixed assets. These decisions are irreversible and usually include the ones pertaining to investing in a building and/or land, acquiring new plants/machinery or replacing the old ones, etc. These decisions determine the financial pursuits and performance of a business.
2. Short-term investment decisions or Working Capital Management means committing funds for a short period of time like current assets. These involve decisions pertaining to the investment of funds in the inventory, cash, bank deposits, and other short-term investments. They directly affect the liquidity and performance of the business.

Financing Decisions: Managers also make decisions pertaining to raising finance from long-term sources (called Capital Structure) and short-term sources (called Working Capital). They are of two types:

1. Financial Planning decisions which relate to estimating the sources and application of funds. It means pre-estimating financial needs of an organization to ensure the availability of adequate finance. The primary objective of financial planning is to plan and ensure that the funds are available as and when required.
2. Capital Structure decisions which involve identifying sources of funds. They also involve decisions with respect to choosing external sources like issuing shares, bonds, borrowing from banks or internal sources like retained earnings for raising funds.

Dividend Decisions: These involve decisions related to the portion of profits that will be distributed as dividend. Shareholders always demand a higher dividend, while the management would want to retain profits for business needs. Hence, this is a complex managerial decision.

Long-Term Sources of Finance

Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building, etc of business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of funds. Long-term financeing sources can be in the form of any of them:

1. Retained Earnings or Internal Accruals
2. Debenture / Bonds
3. Term Loans from Financial Institutes, Government, and Commercial Banks
4. Venture Funding
5. Asset Securitization
6. International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR, etc.

introductory idea about capitalization

Capitalization comprises of share capital, debentures, loans, free reserves,etc. Capitalization represents permanent investment in companies excluding long-term loans. Capitalization can be distinguished from capital structure. Capital structure is a broad term and it deals with qualitative aspect of finance. While capitalization is a narrow term and it deals with the quantitative aspect.

Capitalization is the recordation of a cost as an asset, rather than an expense. This approach is used when a cost is not expected to be entirely consumed in the current period, but rather over an extended period of time.

What it is:

In the business world, capitalization has two meanings. The first meaning, also called market capitalization, refers to the value of a company's outstanding shares. The formula for market capitalization is:

Market Capitalization = Current Stock Price x Shares Outstanding

It is important to note that market cap is not the same as equity value, nor is it equal to a company's debt plus its shareholders' equity (although that too is sometimes referred to as simply the company's capitalization).

The second meaning of the term relates to the act of accounting for a cost as an asset instead of an expense.

Capitalization reflects the theoretical value of a company, but this is usually not what the company could be purchased for in a normal merger transaction. One reason for this is that the value of material nonpublic information, management changes, operating synergies between the acquirer and the company, and other intangible factors may not be reflected in the stock price or the financial statements.

Capital structure

Capital Structure refers to the amount of debt and/or equity employed by a firm to fund its operations and finance its assets. The structure is typically expressed as a debt-to-equity or debt-to-capital ratio.

Debt and equity capital are used to fund a business' operations, capital expenditures, acquisitions, and other investments. There are tradeoffs firms have to make when they decide whether to raise debt or equity and managers will balance the two try and find the optimal capital structure.

Optimal capital structure

The optimal capital structure of a firm is often defined as the proportion of debt and equity that result in the lowest weighted average cost of capital (WACC) for the firm.

Dynamics of debt and equity

Below is an illustration of the dynamics between debt and equity from the view of investors and the firm.

dynamics of debt and equity on capital structure

Debt investors take less risk because they have the first claim on the assets of the business in the event of bankruptcy. For this reason, they accept a lower rate of return, and thus the firm has a lower cost of capital when it issues debt compared to equity.

Equity investors take more risk as they only receive the residual value after debt investors have been repaid. In exchange for this risk equity investors expect a higher rate of return and therefore the implied cost of equity is greater than that of debt.

Cost of capital

A firm's total cost of capital is a weighted average of the cost of equity and the cost of debt, known as the weighted average cost of capital (WACC).The formula is equal to:

WACC = (E/V x Re) + ((D/V x Rd) x (1 – T))

Where:

E = market value of the firm's equity (market cap)

D = market value of the firm's debt

V = total value of capital (equity plus debt)

E/V = percentage of capital that is equity

D/V = percentage of capital that is debt

Re = cost of equity (required rate of return)

Rd = cost of debt (yield to maturity on existing debt)

T = tax rate

Importance of Cost of Capital

1. It helps in evaluating the investment options, by converting the future cash flows of the investment avenues into present value by discounting it.
2. It is helpful in capital budgeting decisions regarding the sources of finance used by the company.
3. It is vital in designing the optimal capital structure of the firm, wherein the firm's value is maximum, and the cost of capital is minimum.
4. It can also be used to appraise the performance of specific projects by comparing the performance against the cost of capital.
5. It is useful in framing optimum credit policy, i.e. at the time of deciding credit period to be allowed to the customers or debtors, it should be compared with the cost of allowing credit period.

Cost of capital is also termed as cut-off rate, the minimum rate of return, or hurdle rate.

Explicit cost of capital:

It is the cost of capital in which firm's cash outflow is oriented towards utilisation of capital which is evident, such as payment of dividend to the shareholders, interest to the debenture holders, etc.

Implicit cost of capital:

It does not involve any cash outflow, but it denotes the opportunity foregone while opting for another alternative opportunity.

To cover the cost of raising funds from the market, cost of capital must be obtained. It helps in assessing firm's new projects because it is the minimum return expected by the shareholders, lenders and debtholders for supplying capital to the business, as a consideration for their share in the total capital. Hence, it establishes a benchmark, which must be met out by the project.

Cost of debt

A company's cost of debt is the effective interest rate a company pays on its debt obligations, including bonds, mortgages, and any other forms of debt the company may have. Because interest expense is deductible, it's generally more useful to determine a company's after-tax cost of debt. Cost of debt, along with cost of equity, makes up a company's cost of capital.

Calculating cost of debt

In order to calculate a company's cost of debt, you'll need two pieces of information: the effective interest rate it pays on its debt and its marginal tax rate.

Many companies publish their average debt interest rate, but if not, it's fairly easy to calculate using the company's financial statements. On the income statement, you can find the total interest the company paid (note: If you're looking at a quarterly income statement, multiply this figure by four in order to annualize the data). Then, on the balance sheet, you can find the total amount of debt the company is carrying. Divide the annual interest by total debt and then multiply the result by 100, and you'll get the effective interest rate on the company's debt obligations.

Keep in mind that this isn't a perfect calculation, as the amount of debt a company carries can vary throughout the year. If you'd like a more reliable result, then you can use the average of the company's debt load from its four most recent quarterly balance sheets.

Next, determine the company's marginal tax rate (federal and state combined). For most large corporations, the federal marginal tax rate is 35%, as this rate applies to all income over $18.33 million. State corporate income taxes range from 0% to 12% as of 2016.

Finally, to calculate the after-tax cost of debt, simply subtract the company's marginal tax rate from one and then multiply the result by the effective tax rate you found earlier.

B.C.A study

Unit-5: Working Capital

Concept & Components of working Capital

Meaning:

In an ordinary sense, working capital denotes the amount of funds needed for meeting day-to-day operations of a concern.

This is related to short-term assets and short-term sources of financing. Hence it deals with both, assets and liabilities—in the sense of managing working capital it is the excess of current assets over current liabilities

Concept of Working Capital:

The funds invested in current assets are termed as working capital. It is the fund that is needed to run the day-to-day operations. It circulates in the business like the blood circulates in a living body. Generally, working capital refers to the current assets of a company that are changed from one form to another in the ordinary course of business, i.e. from cash to inventory, inventory to work in progress (WIP), WIP to finished goods, finished goods to receivables and from receivables to cash.

There are two concepts in respect of working capital:

(i) Gross working capital and

(ii) Net working capital.

Gross Working Capital:

The sum total of all current assets of a business concern is termed as gross working capital. The term 'gross working capital' refers to the firm's investment in current assets. According to this concept working capital refers to a firm's investment in current assets. The amount of current liabilities is not deducted from the total of current assets.So,

Gross working capital = Stock + Debtors + Receivables + Cash.

Net Working Capital:

The difference between current assets and current liabilities of a business concern is termed as the Net working capital.Hence

Net working capital= Stock+debtors+recievables+Cash-Creditors-Payables

Components of Working Capital:

1. Current Assets:

Current assets are those assets which are convertible into cash within a period of one year and are those which are required to meet the day to day operations of the business. The working capital management, to be more precise the management of current assets. The current assets are cash or near cash resources.

These include:

(a) Cash and bank balances,

(b) Temporary investments,

(c) Short-term advances,

(d) Prepaid expenses,

(e) Receivables,

(f) Inventory of raw materials, stores and spares,

(g) Inventory of work-in-progress, and

(h) Inventory of finished goods.

2. Current Liabilities:

Current liabilities are those claims of outsiders which are expected to mature for payment within an accounting year.

These include:

(1) Creditors for goods purchased,

(2) Outstanding expenses,

(3) Short-term borrowings,

(4) Advances received against sales,

(5) Taxes and dividends payable, and

(6) Other liabilities maturing within a year.

Objectives of Working Capital Management:

The basic objectives of working capital management are as follows:

(a) By optimizing the investment in current assets and by reducing the level of current liabilities, the company can reduce the locking-up of funds in working capital thereby, it can improve the return on capital employed in the business.

(b) The second important objective of working capital management is that the company should always be in a position to meet its current obligations which should properly be supported by the current assets available with the firm. But maintaining excess funds in working capital means locking of funds without return.

(c) The firm should manage its current assets in such a way that the marginal return on investment in these assets is not less than the cost of capital employed to finance the current assets.

(d) The firm should maintain proper balance between current assets and current liabilities to enable the firm to meet its day to day financial obligations.

Factors Affecting the Composition of Working Capital

Availability of Raw Materials

Availability of raw materials affects the composition of the working capital. When your company is using readily available raw materials, minimal working capital will be needed, because there will be no need to stock such materials in large volumes. But if your company makes use of seasonal raw materials needed for production all year, then you need to hold large quantities; this requires more working capital.

Nature of Business

Working capital requirements vary by industry. For instance, businesses in the service industry require a low level of working capital because they do not pay cash for inventory. Companies in a manufacturing sector, however, require a higher level of working capital because it takes some time to produce and then sell their goods. Therefore, it is important for you to determine the best-fit working capital requirements based on the nature of your business.

Operation Efficiency

Operating efficiency entails how fast you can convert raw materials to finished goods, sell these finished products and claim your payments from customers. High-efficiency businesses require less working capital. However, in the case of lower operating efficiency, your company will require more working capital.

Rate of Growth and Expansion

A company that is in a period of growth and expansion requires more working capital than a company that is static. Growing companies face an increase in the cost of business operations in terms of production and sales. To meet the production and sales needs of the business, you need more working capital. Therefore, if you want to grow or expand your business, you should start by planning to increase the working capital reserves.

Business Cycle:

The need for the working capital is affected by various stages of the business cycle. During the boom period, the demand of a product increases and sales also increase. Therefore, more working capital is needed. On the contrary, during the period of depression, the demand declines and it affects both the production and sales of goods. Therefore, in such a situation less working capital is required.

Production cycle

Production cycle means the time involved in converting raw material into finished product. The longer this period, the more will be the time for which the capital remains blocked in raw material and semi-manufactured products.

Thus, more working capital will be needed. On the contrary, where period of production cycle is little, less working capital will be needed.

Credit Allowed:

Those enterprises which sell goods on cash payment basis need little working capital but those who provide credit facilities to the customers need more working capital.

Level of Competition:

High level of competition increases the need for more working capital. In order to face competition, more stock is required for quick delivery and credit facility for a long period has to be made available.

Liquidity vs Profitability

Meaning of Liquidity:

Liquidity means one's ability to meet claims and obligations as and when they become due. In the context of an asset, it implies convertibility of the same ultimately into Cash and it has two dimensions in it, viz., time and risk.

The time dimension of liquidity is concerned the speed with which an asset can be convertedinto Cash Risk dimension is concerned with the degree of certainty with which an asset can be converted into Cash without any sacrifice in its book value.

Measurement of Liquidity:

The liquidity is normally measured with the help of the following financial ratios:

(a) Current Ratio;

(b) Liquid Ratio;

(c) Absolute Liquidity Ratio;

(a) Current Ratio:

It is the relation between the amount of current assets and the amount of current liabilities. It is essentially a tool for measuring short-term liquidity and solvency position of firms.Generally, a 2 : 1 ratio is considered as normal and it expresses the satisfactory liquidity position

(b) Liquid Ratio:

It is the ratio between total liquid assets to total liquid liabilities. The normal for such ratio is taken to be 1:1

(c) Absolute Liquidity Ratio:

Liquid ratio measures the relationship between cash and near cash items on the one hand and immediately maturing obligation on the other.

Meaning of Profitability:

Profitability of a firm is represented by the rate of return on its capital employed.

This is measured as:

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(https://cdn.accountingnotes.net/wp-content/uploads/2016/06/clip_image017_thumb2-1.jpg)

It is clear from the above that the ratio between Net Profit and Sales, can be increased either by reducing the Cost of Sales or by increasing the volume of sales. Reduction in cost of sales is possible only when there is an effective management of working capital.

In the second alternative, increase in sales is associated with increase in variable cost. And therefore, only an optimum use of working capital can ensure increase in profitability due to increase in sales.

B.C.A study

Unit-6: Cash management,inventory management and recievable management

Definition: Cash Management refers to the collection, handling, control and investment of the organizational cash and cash equivalents, to ensure optimum utilization of the firm's liquid resources. Money is the lifeline of the business, and therefore it is essential to maintain a sound cash flow position in the organization.

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Receivables Cash Management

Any amount which the company has earned however not yet received, i.e. its outstanding and is expected to be received in future, is known as receivables.

An organization must manage its receivables to maintain the surplus cash inflow. It helps the firm to fulfil its immediate cash requirements.

The cash receivables must be planned in such a way that the organization can realise its debts quickly and should allow a short credit period to the debtors.

Payables Cash Management

The payables refer to the payment which is unpaid by the organization and is to be paid off shortly.

The organization should plan its cash outflow in such a manner that it can acquire an extended credit period from the creditors.

This helps the firm to retain its cash resources for a longer duration to meet the short term requirements and sudden expenses. Even the organization can invest this cash in a profitable opportunity for that particular credit period to generate additional income.

Objectives of Cash Management

- **Fulfil Working Capital Requirement**: The organization needs to maintain ample liquid cash to meet its routine expenses which possible only through effective cash management.
- **Planning Capital Expenditure**: It helps in planning the capital expenditure and determining the ratio of debt and equity to acquire finance for this purpose.
- **Handling Unorganized Costs**: There are times when the company encounters unexpected circumstances like the breakdown of machinery. These are unforeseen expenses to cope up with; cash surplus is a lifesaver in such conditions.

- **Initiates Investment**: The other aim of cash management is to invest the idle funds in the right opportunity and the correct proportion.
- **Better Utilization of Funds**: It ensures the optimum utilization of the available funds by creating a proper balance between the cash in hand and investment.
- **Avoiding Insolvency**: If the business does not plan for efficient cash management, the situation of insolvency may arise. It is either due to lack of liquid cash or not making a profit out of the money available.

Functions of Cash Management

Cash management is required by all kinds of organizations irrespective of their size, type and location. Following are the multiple managerial functions related to cash management:

- **Investing Idle Cash**: The company needs to look for various short term investment alternatives to utilize surplus funds.

- **Controlling Cash Flows**: Restricting the cash outflow and accelerating the cash inflow is an essential function of the business.
- **Planning of Cash**: Cash management is all about planning and decision making in terms of maintaining sufficient cash in hand and making wise investments.
- **Managing Cash Flows**: Maintaining the proper flow of cash in the organization through cost-cutting and profit generation from investments is necessary to attain a positive cash flow.
- **Optimizing Cash Level**: The organization should continuously function to maintain the required level of liquidity and cash for business operations.

Cash Management Strategies

Business Line of Credit: The organization should opt for a business line of credit at an initial stage to meet the urgent cash requirements and unexpected expenses.

Money Market Fund: While carrying on a business, the surplus fund should be invested in the money market funds. These are readily convertible into cash whenever required and yield a considerable profit over the period.

Lockbox Account: This facility provided by the banks enable the companies to get their payments mailed to its post office box. This lockbox is managed by the banks to avoid manual deposit of cash regularly.

Sweep Account: The organizations should avail the facility of sweep accounts which is a mix of savings and fixed deposit account. Thus, the minimum balance of the savings account is automatically maintained, and the excess sum is transferred to the fixed deposit account.

Cash Deposits (CDs): If the company has a sound financial position and can predict the expenses well along with availing of a lengthy period, it can invest the surplus cash in the cash deposits. These CDs yield good interest, but early withdrawals are liable to penalties.

Limitations of Cash Management

Cash management is an inevitable part of business organizations. However, it has a few shortcomings which make it unsuitable for small organizations; these are as follows:

Cash management is a **very time consuming** and skilful activity which is required to be performed regularly.

As it requires financial expertise, the company may need to hire consultants or other experts to perform the task by paying **administrative and consultation charges**.

Small business entities which are managed solely, **face problems** such as lack of skills, knowledge, time and risk-taking ability to practice cash management.

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