
Dr Shubhangee L Diwe
Dept of Commerce
Baliram patil college Kinwat

Important Questions

Short Notes:

1. Marginal Costing

Marginal costing as used in management accounting, **Marginal costing** is the accounting system in which variable costs are charged to **cost** units and fixed costs of the period are written off in full against the aggregate contribution.

Following is the Marginal Cost statement

Marginal Cost Statement

| | |
|-----------------------|-------|
| ➤ Sales | xxxxx |
| ➤ Less: Variable Cost | xxxxx |
| ➤ Contribution | xxxxx |
| ➤ Less: Fixed Cost | xxxxx |
| ➤ Profit / Loss | xxxxx |

2. Profit Volume Ratio-

The **Profit Volume (PV) Ratio** is the **ratio** of Contribution over Sales. It measures the Profitability of the firm and is one of the important **ratios** for computing profitability. The Contribution is the extra amount of sales over variable cost. However a doubt arises. For “Debt Equity **Ratio**”, the **formula** is

Profit Volume Ratio=

$$\frac{\text{Contribution}}{\text{Sales}} \times 100$$

Or

$$= \frac{\text{Change on Profit}}{\text{Change in Sales}} \times 100$$

3. Cash Budget

Definition: A cash budget is a budget or plan of expected cash receipts and disbursements during the period. These cash inflows and outflows include revenues collected, expenses paid, and loans receipts and payments. In other words, a cash budget is an estimated projection of the company's cash position in the future.

Management usually develops the cash budget after the sales, purchases, and capital expenditures budgets are already made. These budgets need to be made before the cash budget in order to accurately estimate how cash will be affected during the period. For example, management needs to know a sales estimate before it can predict how much cash will be collected during the period.

Management uses the cash budget to manage the cash flows of a company. In other words, management must make sure the company has enough cash to pay its bills when they come due. For instance, payroll must be paid every two weeks and utilities must be paid every month. The cash budget allows management to predict short falls in the company's cash balance and correct the problems before payments are due.

4. Standard Costing

An estimated or predetermined cost of performing an operation or producing a good or service, under normal conditions. Standard costs are used as target costs (or basis for comparison with the actual costs), and are developed from historical data analysis or from time and motion studies.

Standard costs are sometimes referred to as preset costs because they are estimated based on statistics and management's experience. Basically, management calculates how much each step in the production process should cost based on the market value of goods, median wages paid per employee, and average utility rates. This estimated calculated amount is the standard cost. It's the amount that the company should have to pay to produce a good.

5. Cash Flow Statement

Cash flow statement, also known as **statement of cash flows**, is a financial **statement** that shows how changes in balance sheet accounts and income affect **cash** and **cash** equivalents, and breaks the analysis down to operating, investing and financing activities.

Why Cash Flow Statement is prepared.

1. To show how cash has been used during an accounting period.
2. This can help a business prepare a strategy when going to market.

3. Most banks and lenders want to see positive cash flow, as do stake holders and investors.
4. For taking Bank loan cash flow statement is prepared.
5. For Audit Report & for Showing financial Situation of firm.

6. Margin of safety

Margin of safety (safety margin) is the difference between the intrinsic value of a stock and its market price. Another definition: In Break even analysis (accounting), margin of safety is how much output or sales level can fall before a business reaches its breakeven point.

Margin of Safety = Total Sales – break Even Point Sales

$$\text{Or} \\ \frac{\text{Profit}}{\text{P/V Ratio}}$$

7. Material Usage Variance (MUV)

In variance analysis, direct material usage (efficiency, quantity) variance is the difference between the standard quantity of materials that should have been used for the number of units actually produced, and the actual quantity of materials used, valued at the standard cost per unit of material.

MUV= Standard Price (Standard Quantity - Actual Quantity)

Material Price Variance

Direct Material Price Variance is the difference between the actual cost of direct material and the standard cost of quantity purchased or consumed.

A favorable material price variance suggests cost effective procurement by the company.

Reasons for a favorable material price variance may include:

An overall decrease in the market price level

- Purchase of materials of lower quality than the standard (this will be reflected in adverse material usage variance)
- Better price negotiation by the procurement staff
- Implementation of better procurement practices (e.g. invitation of price quotations from multiple suppliers)
- Purchase discounts on larger orders

MPV= Actual Quantity (Standard Price – Actual Price)

Material Cost Variance:

Material cost variance is the deviation from the standard direct material cost, of the actual production volume and the actual cost of direct material. Material cost variance is also concerned as a sum of the direct material usage and price variances. The variances can be favorable or unfavorable. If the actual cost is lower than the standard cost, it is considered as favorable variance and if the actual cost exceeds the standard cost, the difference is unfavorable. There is not any rule of thumb for the calculation of direct material cost variances.

MCV= Standard Cost - Actual Cost

Or

(Standard Qty X Standard Price) – (Actual Qty X Actual Price)

Labour Variances

Direct Labor Rate Variance

Definition

Direct Labor Rate Variance is the measure of difference between the actual cost of direct labor and the standard cost of direct labor utilized during a period.

LRV= Actual time (Standard Rate – Actual rate)

A favorable labor rate variance suggests cost efficient employment of direct labor by the organization.

Reasons for a favorable labor rate variance may include:

- Hiring of more un-skilled or semi-skilled labor (this may adversely impact labor efficiency variance)
- Decrease in the overall wage rates in the market due to an increase in the supply of labor which may be caused, for example, due to the influx of immigrants as a result of the relaxation of immigration policy
- Inappropriately high setting of the standard cost of direct labor which may, in the hindsight, be attributed to inaccurate planning
- An adverse labor rate variance indicates higher labor costs incurred during a period compared with the standard.
- Causes for adverse labor rate variance may include:
- Increase in the national minimum wage rate

- Hiring of more skilled labor than anticipated in the standard (this should be reflected in a favorable labor efficiency variance)
- Inefficient hiring by the HR department
- Effective negotiations by labor unions

Direct Labor Efficiency Variance

Definition

Direct Labor Efficiency Variance is the measure of difference between the standard cost of actual number of direct labor hours utilized during a period and the standard hours of direct labor for the level of output achieved.

$$\text{LEV} = \text{Standard Rate} (\text{Actual Hours} - \text{Standard hours})$$

A favorable labor efficiency variance indicates better productivity of direct labor during a period.

Causes for favorable labor efficiency variance may include:

- Hiring of more higher skilled labor (this may adversely impact labor rate variance)
- Training of work force in improved production techniques and methodologies
- Use of better quality raw materials which are easier to handle
- Higher learning curve than anticipated in the standard
- An adverse labor efficiency variance suggests lower productivity of direct labor during a period compared with the standard.
- Reasons for adverse labor efficiency variances may include:
 - Hiring of lower skilled labor than the standard (this should be reflected in a favorable labor rate variance)
 - Lower learning curve achieved during the period than anticipated in the standard
 - Decrease in staff morale and motivation

Direct Labor Idle Time Variance

Definition

Labor Idle Time Variance is the cost of the standby time of direct labor which could not be utilized in the production due to reasons including mechanical failure of equipment, industrial disputes and lack of orders.

$$\text{LITV} = \text{Idle Time} \times \text{Standard Rate}$$

Analysis

Reasons for idle time may include:

- Disruption of production activities due to mechanical failures
- Lack of purchase orders especially in case of seasonal businesses
- Industrial disputes

Labour Cost Variance

It is the difference between the standard cost of labour allowed (as per standard laid down) for the actual output achieved and the actual cost of labour employed. It is also known as wages variance.

Formula: LCV=Standard Cost – Actual Cost

(Standard Rate X Standard time) – (Actual Rate X Actual Time)

Direct Costing:

Direct costing is a specialized form of cost analysis that only uses variable costs to make decisions. It does not consider fixed costs, which are assumed to be associated with the time periods in which they were incurred. The direct costing concept is extremely useful for short-term decisions, but can lead to harmful results if used for long-term decision making, since it does not include all costs that may apply to a longer-term decision.

In brief, direct costing is the analysis of incremental costs. Direct costs are most easily illustrated through examples, such as:

- The costs actually consumed when you manufacture a product
- The incremental increase in costs when you ramp up production
- The costs that disappear when you shut down a production line
- The costs that disappear when you shut down an entire subsidiary

Flexible Budget

A flexible budget, also called a variable budget, is financial plan of estimated revenues and expenses based on the current actual amount of output. In other words, a flexible budget uses the revenues and expenses produced in the current production as a baseline and estimates how the revenues and expenses will change based on changes in the output. This is why it's often called a variable budget. Management often uses flexible budgets before a period to predict both a best case and worse case scenario for the upcoming accounting period.

This provides a “what if” look at the future of the company's financial performance. Flexible budgets can also be used after an accounting period to evaluate the successful areas and unsuccessful areas of the last period performance. Management carefully compares the budgeted numbers with the actual performance statistics to see where the company improved and where the company needs more improvement.

Production Budget

The production budget calculates the number of units of products that must be manufactured, and is derived from a combination of the sales forecast and the planned amount of finished goods inventory to have on hand (usually as safety stock to cover for unexpected increases in demand). The production budget is typically prepared for a "push" manufacturing system, as is used in a material requirements planning environment.

The production budget is typically presented in either a monthly or quarterly format.

The basic calculation used by the production budget is:

+ Forecasted unit sales

+ Planned finished goods ending inventory balance

= Total production required

- Beginning finished goods inventory

= Products to be manufactured

Stock/Inventory Turnover Ratio

The inventory turnover ratio is an efficiency ratio that shows how effectively inventory is managed by comparing cost of goods sold with average inventory for a period. This measures how many times average inventory is "turned" or sold during a period. In other words, it measures how many times a company sold its total average inventory dollar amount during the year.

This ratio is important because total turnover depends on two main components of performance. The first component is stock purchasing. If larger amounts of inventory are purchased during the year, the company will have to sell greater amounts of inventory to improve its turnover. If the company can't sell these greater amounts of inventory, it will incur storage costs and other holding costs.

The second component is sales. Sales have to match inventory purchases otherwise the inventory will not turn effectively. That's why the purchasing and sales departments must be in tune with each other.

The inventory turnover ratio is calculated by dividing the cost of goods sold for a period by the average inventory for that period.

Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Debtors Turnover Ratio or Receivable Turnover Ratio:

Definition and Explanation:

Ratio of net credit sales to average trade debtors is called debtors turnover ratio. It is also known as receivables turnover ratio. This ratio is expressed in times.

Accounts receivables is the term which includes trade debtors and bills receivables. It is a component of current assets and as such has direct influence on working capital position (liquidity) of the business. Perhaps, no business can afford to make cash sales only thus extending credit to the customers is a necessary evil. But care must be taken to collect book debts quickly and within the period of credit allowed. Otherwise chances of debts becoming bad and unrealizable will increase.

How effective or efficient is the credit collection? To provide answer debtors turnover ratio or receivable turnover ratio is calculated.

Formula:

Receivables turnover ratio = Annual net credit sales / Average accounts receivables

Where accounts receivables = Trade debtors + Bills receivables

Liquid Assets

A liquid asset is cash on hand or an asset that can be readily converted to cash. An asset that can readily be converted into cash is similar to cash itself because the asset can be sold with little impact on its value. ... Investments are considered liquid assets because they can be readily liquidated.

Liquid Assets = Current Assets – Stock.

Current Assets

A current asset is an item on an entity's balance sheet that is either cash, a cash equivalent, or which can be converted into cash within one year. If an organization has an operating cycle lasting more than one year, an asset is still classified as current as long as it is converted into cash within the operating cycle.

Examples of current assets are:

- Cash
- Investments,
- Prepaid expenses
- Accounts receivable
- Inventory

Advantages & Disadvantages of Marginal Costing

Meaning of Marginal Costing:

Marginal costing is "The ascertainment, by differentiating between fixed cost and variable cost, of marginal cost and of the effect on profit of changes in volume or type of output".

Under this technique all costs are classified into fixed costs and variable costs.

Features of Marginal Costing:

- (i) This technique is used to ascertain the marginal cost and to know the impact of variable costs on the volume of output.
- (ii) All costs are classified on the basis of variability into fixed cost and variable cost. Semi-variable costs are segregated into fixed and variable costs.
- (iii) Marginal (i.e., variable) costs are treated as the cost of the product or service. Fixed costs are charged to Costing Profit and Loss Account of the period in which they are incurred.
- (iv) Stock of finished goods and work-in-progress are valued on the basis of marginal costs.
- (v) Selling price is based on marginal cost plus contribution.
- (vi) Profit is calculated in the usual manner. When marginal cost is deducted from sales it gives rise to contribution. When fixed cost is deducted from contribution it results in profit.
- (vii) Break-even analysis and cost-volume profit analysis are integral parts of this technique.

Advantages of Marginal Costing:

- (i) The technique is simple to understand and easy to operate because it avoids the complexities of apportionment of fixed costs which, is really, arbitrary.
- (ii) It also avoids the carry forward of a portion of the current period's fixed overhead to the subsequent period. As such cost and profit are not vitiated. Cost comparisons become more meaningful.
- (iii) The technique provides useful data for managerial decision-making.
- (iv) There is no problem of over or under-absorption of overheads.
- (v) The impact of profit on sales fluctuations are clearly shown under marginal costing.
- (vi) The technique can be used along with other techniques such as budgetary control and standard costing.
- (vii) It establishes a clear relationship between cost, sales and volume of output and breakeven analysis.
- (viii) It shows the relative contributions to profit which are made by each of a number of products, and shows where the sales effort should be concentrated.
- (ix) Stock of finished goods and work-in-progress are valued at marginal cost, which is uniform.

Limitations of Marginal Costing:

- (i) Segregation of costs into fixed and variable elements involves considerable technical difficulty.
- (ii) The linear relationship between output and variable costs may not be true at different levels of activity. In reality, neither the fixed costs remain constant nor do the variable costs vary in proportion to the level of activity.
- (iii) The value of stock cannot be accepted by taxation authorities since it deflates profit.
- (iv) This technique cannot be applied in the case of contract costing where the value of work-in-progress will always be high.
- (v) This technique also cannot be used in the case of cost plus contracts unless fixed costs and profits are considered.
- (vi) Pricing decisions cannot be based on contribution alone.
- (vii) The elimination of fixed costs renders cost comparison of jobs difficult.
- (viii) The distinction between fixed and variable costs holds good only in the short run. In the long run, however, all costs are variable.
- (ix) With the increased use of automatic machinery, the proportion of fixed costs increases. A system which ignores fixed costs is, therefore, less effective.
- (x) The technique need not be considered to be unique from the point of cost control.

Advantages & Disadvantages of Standard Costing

An estimated or predetermined **cost** of performing an operation or producing a good or service, under normal conditions. **Standard** costs are used as target costs (or basis for comparison with the actual costs), and are developed from historical data analysis or from time and motion studies.

Advantages of Standard Costing:

1. **Management by Exception** The standard costing is an example of management by exception. By studying the variances, management's attention is directed towards those items, which are not proceeding according to the plan. Most of the management's time is saved and can be directed to other value adding activities. Management
2. **Cost Reduction** The process of setting, revising and monitoring standards encourages reappraisal of methods, materials and techniques thus leading to cost reductions. Analysis of unfavourable variances directs cost analysis to factors that are making costs to exceed the budgeted costs thus these factors can be controlled, leading to cost reduction.
3. **Pricing** Standard costs serve as a reliable base of calculating total cost of producing a good or service, to which a margin can be added to determine the selling price.
4. **Inventory Valuation** Standard costing makes inventory valuation much easier, if the actual number of physical units in the inventory is known, then the inventory value is simply determined by multiplying the standard cost per unit by the physical units.
5. **Motivation** A properly developed standard costing system requires the full participation of all management levels (upper, middle and lower levels) and the employees. This creates motivation for the employees as they feel part of the system.
6. **Cost Control** A well implemented standard costing system acts as a yardstick against which all costs are measured to determine whether the variance from the standard is favourable or unfavourable. This creates cost consciousness in the organization and in the end enables the organization to control costs.
7. **Budgeting is made easier** One of the greatest benefits of standard costing is to be found in setting budgets for the organization and its departments. As earlier illustrated once the desired output units are known, then the budgeted cost is simply the output units desired multiplied by the standard cost per unit.

i.e. Budgeted Cost = Output units x Standard Cost per unit

Disadvantages of Standard Costing

1. **The system of standard costing is expensive to install** A lot of money is spent in studying output requirements in terms of labour, materials and overheads.
2. **Time Consuming** A lot of time is also spent in developing and installing reliable standard costing systems.
3. **Obsolescence:** In fast changing conditions (e.g. in hyperinflationary economies where prices of labour, materials and overheads change rapidly), standards become out of date quickly. They therefore lose their control and motivational effects.
4. **Hard to Understand** Some standard costing systems are overly elaborate and are therefore not well understood by line managers and employees. This makes their implementation difficult.

Dayanand College of Commerce, Latur

Prof. Premsagar S. Mundada

BBA Third Year (VI-SEM)

Cost & Management A/c-II

Important Questions

Short Notes:

1. Marginal Costing

Marginal costing as used in management accounting, **Marginal costing** is the accounting system in which variable costs are charged to **cost** units and fixed costs of the period are written off in full against the aggregate contribution.

Following is the Marginal Cost statement

Marginal Cost Statement

| | |
|-----------------------|-------|
| ➤ Sales | xxxxx |
| ➤ Less: Variable Cost | xxxxx |
| ➤ Contribution | xxxxx |
| ➤ Less: Fixed Cost | xxxxx |
| ➤ Profit / Loss | xxxxx |

2. Profit Volume Ratio-

The **Profit Volume (PV) Ratio** is the **ratio** of Contribution over Sales. It measures the Profitability of the firm and is one of the important **ratios** for computing profitability. The Contribution is the extra amount of sales over variable cost. However a doubt arises. For “Debt Equity **Ratio**”, the **formula** is

Profit Volume Ratio=

$$\frac{\text{Contribution}}{\text{Sales}} \times 100$$

Or

$$= \frac{\text{Change on Profit}}{\text{Change in Sales}} \times 100$$

3. Cash Budget

Definition: A cash budget is a budget or plan of expected cash receipts and disbursements during the period. These cash inflows and outflows include revenues collected, expenses paid, and loans receipts and payments. In other words, a cash budget is an estimated projection of the company's cash position in the future.

Management usually develops the cash budget after the sales, purchases, and capital expenditures budgets are already made. These budgets need to be made before the cash budget in order to accurately estimate how cash will be affected during the period. For example, management needs to know a sales estimate before it can predict how much cash will be collected during the period.

Management uses the cash budget to manage the cash flows of a company. In other words, management must make sure the company has enough cash to pay its bills when they come due. For instance, payroll must be paid every two weeks and utilities must be paid every month. The cash budget allows management to predict short falls in the company's cash balance and correct the problems before payments are due.

4. Standard Costing

An estimated or predetermined cost of performing an operation or producing a good or service, under normal conditions. Standard costs are used as target costs (or basis for comparison with the actual costs), and are developed from historical data analysis or from time and motion studies.

Standard costs are sometimes referred to as preset costs because they are estimated based on statistics and management's experience. Basically, management calculates how much each step in the production process should cost based on the market value of goods, median wages paid per employee, and average utility rates. This estimated calculated amount is the standard cost. It's the amount that the company should have to pay to produce a good.

5. Cash Flow Statement

Cash flow statement, also known as **statement of cash flows**, is a financial **statement** that shows how changes in balance sheet accounts and income affect **cash** and **cash** equivalents, and breaks the analysis down to operating, investing and financing activities.

Why Cash Flow Statement is prepared.

1. To show how cash has been used during an accounting period.
2. This can help a business prepare a strategy when going to market.

3. Most banks and lenders want to see positive cash flow, as do stake holders and investors.
4. For taking Bank loan cash flow statement is prepared.
5. For Audit Report & for Showing financial Situation of firm.

6. Margin of safety

Margin of safety (safety margin) is the difference between the intrinsic value of a stock and its market price. Another definition: In Break even analysis (accounting), margin of safety is how much output or sales level can fall before a business reaches its breakeven point.

Margin of Safety = Total Sales – break Even Point Sales

Or

$$\frac{\text{Profit}}{\text{P/V Ratio}}$$

7. Material Usage Variance (MUV)

In variance analysis, direct material usage (efficiency, quantity) variance is the difference between the standard quantity of materials that should have been used for the number of units actually produced, and the actual quantity of materials used, valued at the standard cost per unit of material.

MUV= Standard Price (Standard Quantity - Actual Quantity)

Material Price Variance

Direct Material Price Variance is the difference between the actual cost of direct material and the standard cost of quantity purchased or consumed.

A favorable material price variance suggests cost effective procurement by the company.

Reasons for a favorable material price variance may include:

An overall decrease in the market price level

- Purchase of materials of lower quality than the standard (this will be reflected in adverse material usage variance)
- Better price negotiation by the procurement staff
- Implementation of better procurement practices (e.g. invitation of price quotations from multiple suppliers)
- Purchase discounts on larger orders

MPV= Actual Quantity (Standard Price – Actual Price)

Material Cost Variance:

Material cost variance is the deviation from the standard direct material cost, of the actual production volume and the actual cost of direct material. Material cost variance is also concerned as a sum of the direct material usage and price variances. The variances can be favorable or unfavorable. If the actual cost is lower than the standard cost, it is considered as favorable variance and if the actual cost exceeds the standard cost, the difference is unfavorable. There is not any rule of thumb for the calculation of direct material cost variances.

MCV= Standard Cost - Actual Cost

Or

(Standard Qty X Standard Price) – (Actual Qty X Actual Price)

Labour Variances

Direct Labor Rate Variance

Definition

Direct Labor Rate Variance is the measure of difference between the actual cost of direct labor and the standard cost of direct labor utilized during a period.

LRV= Actual time (Standard Rate – Actual rate)

A favorable labor rate variance suggests cost efficient employment of direct labor by the organization.

Reasons for a favorable labor rate variance may include:

- Hiring of more un-skilled or semi-skilled labor (this may adversely impact labor efficiency variance)
- Decrease in the overall wage rates in the market due to an increase in the supply of labor which may be caused, for example, due to the influx of immigrants as a result of the relaxation of immigration policy
- Inappropriately high setting of the standard cost of direct labor which may, in the hindsight, be attributed to inaccurate planning
- An adverse labor rate variance indicates higher labor costs incurred during a period compared with the standard.
- Causes for adverse labor rate variance may include:
- Increase in the national minimum wage rate

- Hiring of more skilled labor than anticipated in the standard (this should be reflected in a favorable labor efficiency variance)
- Inefficient hiring by the HR department
- Effective negotiations by labor unions

Direct Labor Efficiency Variance

Definition

Direct Labor Efficiency Variance is the measure of difference between the standard cost of actual number of direct labor hours utilized during a period and the standard hours of direct labor for the level of output achieved.

$$\text{LEV} = \text{Standard Rate} (\text{Actual Hours} \times \text{Standard hours})$$

A favorable labor efficiency variance indicates better productivity of direct labor during a period.

Causes for favorable labor efficiency variance may include:

- Hiring of more higher skilled labor (this may adversely impact labor rate variance)
- Training of work force in improved production techniques and methodologies
- Use of better quality raw materials which are easier to handle
- Higher learning curve than anticipated in the standard
- An adverse labor efficiency variance suggests lower productivity of direct labor during a period compared with the standard.
- Reasons for adverse labor efficiency variances may include:
 - Hiring of lower skilled labor than the standard (this should be reflected in a favorable labor rate variance)
 - Lower learning curve achieved during the period than anticipated in the standard
 - Decrease in staff morale and motivation

Direct Labor Idle Time Variance

Definition

Labor Idle Time Variance is the cost of the standby time of direct labor which could not be utilized in the production due to reasons including mechanical failure of equipment, industrial disputes and lack of orders.

$$\text{LITV} = \text{Idle Time} \times \text{Standard Rate}$$

Analysis

Reasons for idle time may include:

- Disruption of production activities due to mechanical failures
- Lack of purchase orders especially in case of seasonal businesses
- Industrial disputes

Labour Cost Variance

It is the difference between the standard cost of labour allowed (as per standard laid down) for the actual output achieved and the actual cost of labour employed. It is also known as wages variance.

Formula: LCV=Standard Cost – Actual Cost

(Standard Rate X Standard time) – (Actual Rate X Actual Time)

Direct Costing:

Direct costing is a specialized form of cost analysis that only uses variable costs to make decisions. It does not consider fixed costs, which are assumed to be associated with the time periods in which they were incurred. The direct costing concept is extremely useful for short-term decisions, but can lead to harmful results if used for long-term decision making, since it does not include all costs that may apply to a longer-term decision.

In brief, direct costing is the analysis of incremental costs. Direct costs are most easily illustrated through examples, such as:

- The costs actually consumed when you manufacture a product
- The incremental increase in costs when you ramp up production
- The costs that disappear when you shut down a production line
- The costs that disappear when you shut down an entire subsidiary

Flexible Budget

A flexible budget, also called a variable budget, is financial plan of estimated revenues and expenses based on the current actual amount of output. In other words, a flexible budget uses the revenues and expenses produced in the current production as a baseline and estimates how the revenues and expenses will change based on changes in the output. This is why it's often called a variable budget. Management often uses flexible budgets before a period to predict both a best case and worse case scenario for the upcoming accounting period.

This provides a “what if” look at the future of the company's financial performance. Flexible budgets can also be used after an accounting period to evaluate the successful areas and unsuccessful areas of the last period performance. Management carefully compares the budgeted numbers with the actual performance statistics to see where the company improved and where the company needs more improvement.

Production Budget

The production budget calculates the number of units of products that must be manufactured, and is derived from a combination of the sales forecast and the planned amount of finished goods inventory to have on hand (usually as safety stock to cover for unexpected increases in demand). The production budget is typically prepared for a "push" manufacturing system, as is used in a material requirements planning environment.

The production budget is typically presented in either a monthly or quarterly format.

The basic calculation used by the production budget is:

+ Forecasted unit sales

+ Planned finished goods ending inventory balance

= Total production required

- Beginning finished goods inventory

= Products to be manufactured

Stock/Inventory Turnover Ratio

The inventory turnover ratio is an efficiency ratio that shows how effectively inventory is managed by comparing cost of goods sold with average inventory for a period. This measures how many times average inventory is "turned" or sold during a period. In other words, it measures how many times a company sold its total average inventory dollar amount during the year.

This ratio is important because total turnover depends on two main components of performance. The first component is stock purchasing. If larger amounts of inventory are purchased during the year, the company will have to sell greater amounts of inventory to improve its turnover. If the company can't sell these greater amounts of inventory, it will incur storage costs and other holding costs.

The second component is sales. Sales have to match inventory purchases otherwise the inventory will not turn effectively. That's why the purchasing and sales departments must be in tune with each other.

The inventory turnover ratio is calculated by dividing the cost of goods sold for a period by the average inventory for that period.

Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Debtors Turnover Ratio or Receivable Turnover Ratio:

Definition and Explanation:

Ratio of net credit sales to average trade debtors is called debtors turnover ratio. It is also known as receivables turnover ratio. This ratio is expressed in times.

Accounts receivables is the term which includes trade debtors and bills receivables. It is a component of current assets and as such has direct influence on working capital position (liquidity) of the business. Perhaps, no business can afford to make cash sales only thus extending credit to the customers is a necessary evil. But care must be taken to collect book debts quickly and within the period of credit allowed. Otherwise chances of debts becoming bad and unrealizable will increase.

How effective or efficient is the credit collection? To provide answer debtors turnover ratio or receivable turnover ratio is calculated.

Formula:

Receivables turnover ratio = Annual net credit sales / Average accounts receivables

Where accounts receivables = Trade debtors + Bills receivables

Liquid Assets

A liquid asset is cash on hand or an asset that can be readily converted to cash. An asset that can readily be converted into cash is similar to cash itself because the asset can be sold with little impact on its value. ... Investments are considered liquid assets because they can be readily liquidated.

Liquid Assets = Current Assets – Stock.

Current Assets

A current asset is an item on an entity's balance sheet that is either cash, a cash equivalent, or which can be converted into cash within one year. If an organization has an operating cycle lasting more than one year, an asset is still classified as current as long as it is converted into cash within the operating cycle.

Examples of current assets are:

- Cash
- Investments,
- Prepaid expenses
- Accounts receivable
- Inventory

Advantages & Disadvantages of Marginal Costing

Meaning of Marginal Costing:

Marginal costing is "The ascertainment, by differentiating between fixed cost and variable cost, of marginal cost and of the effect on profit of changes in volume or type of output".

Under this technique all costs are classified into fixed costs and variable costs.

Features of Marginal Costing:

- (i) This technique is used to ascertain the marginal cost and to know the impact of variable costs on the volume of output.
- (ii) All costs are classified on the basis of variability into fixed cost and variable cost. Semi-variable costs are segregated into fixed and variable costs.
- (iii) Marginal (i.e., variable) costs are treated as the cost of the product or service. Fixed costs are charged to Costing Profit and Loss Account of the period in which they are incurred.
- (iv) Stock of finished goods and work-in-progress are valued on the basis of marginal costs.
- (v) Selling price is based on marginal cost plus contribution.
- (vi) Profit is calculated in the usual manner. When marginal cost is deducted from sales it gives rise to contribution. When fixed cost is deducted from contribution it results in profit.
- (vii) Break-even analysis and cost-volume profit analysis are integral parts of this technique.

Advantages of Marginal Costing:

- (i) The technique is simple to understand and easy to operate because it avoids the complexities of apportionment of fixed costs which, is really, arbitrary.
- (ii) It also avoids the carry forward of a portion of the current period's fixed overhead to the subsequent period. As such cost and profit are not vitiated. Cost comparisons become more meaningful.
- (iii) The technique provides useful data for managerial decision-making.
- (iv) There is no problem of over or under-absorption of overheads.
- (v) The impact of profit on sales fluctuations are clearly shown under marginal costing.
- (vi) The technique can be used along with other techniques such as budgetary control and standard costing.
- (vii) It establishes a clear relationship between cost, sales and volume of output and breakeven analysis.
- (viii) It shows the relative contributions to profit which are made by each of a number of products, and shows where the sales effort should be concentrated.
- (ix) Stock of finished goods and work-in-progress are valued at marginal cost, which is uniform.

Limitations of Marginal Costing:

- (i) Segregation of costs into fixed and variable elements involves considerable technical difficulty.
- (ii) The linear relationship between output and variable costs may not be true at different levels of activity. In reality, neither the fixed costs remain constant nor do the variable costs vary in proportion to the level of activity.
- (iii) The value of stock cannot be accepted by taxation authorities since it deflates profit.
- (iv) This technique cannot be applied in the case of contract costing where the value of work-in-progress will always be high.
- (v) This technique also cannot be used in the case of cost plus contracts unless fixed costs and profits are considered.
- (vi) Pricing decisions cannot be based on contribution alone.
- (vii) The elimination of fixed costs renders cost comparison of jobs difficult.
- (viii) The distinction between fixed and variable costs holds good only in the short run. In the long run, however, all costs are variable.
- (ix) With the increased use of automatic machinery, the proportion of fixed costs increases. A system which ignores fixed costs is, therefore, less effective.
- (x) The technique need not be considered to be unique from the point of cost control.

Advantages & Disadvantages of Standard Costing

An estimated or predetermined **cost** of performing an operation or producing a good or service, under normal conditions. **Standard** costs are used as target costs (or basis for comparison with the actual costs), and are developed from historical data analysis or from time and motion studies.

Advantages of Standard Costing:

1. **Management by Exception** The standard costing is an example of management by exception. By studying the variances, management's attention is directed towards those items, which are not proceeding according to the plan. Most of the management's time is saved and can be directed to other value adding activities. Management
2. **Cost Reduction** The process of setting, revising and monitoring standards encourages reappraisal of methods, materials and techniques thus leading to cost reductions. Analysis of unfavourable variances directs cost analysis to factors that are making costs to exceed the budgeted costs thus these factors can be controlled, leading to cost reduction.
3. **Pricing** Standard costs serve as a reliable base of calculating total cost of producing a good or service, to which a margin can be added to determine the selling price.
4. **Inventory Valuation** Standard costing makes inventory valuation much easier, if the actual number of physical units in the inventory is known, then the inventory value is simply determined by multiplying the standard cost per unit by the physical units.
5. **Motivation** A properly developed standard costing system requires the full participation of all management levels (upper, middle and lower levels) and the employees. This creates motivation for the employees as they feel part of the system.
6. **Cost Control** A well implemented standard costing system acts as a yardstick against which all costs are measured to determine whether the variance from the standard is favourable or unfavourable. This creates cost consciousness in the organization and in the end enables the organization to control costs.
7. **Budgeting is made easier** One of the greatest benefits of standard costing is to be found in setting budgets for the organization and its departments. As earlier illustrated once the desired output units are known, then the budgeted cost is simply the output units desired multiplied by the standard cost per unit.

i.e. Budgeted Cost = Output units x Standard Cost per unit

Disadvantages of Standard Costing

1. **The system of standard costing is expensive to install** A lot of money is spent in studying output requirements in terms of labour, materials and overheads.
2. **Time Consuming** A lot of time is also spent in developing and installing reliable standard costing systems.
3. **Obsolescence:** In fast changing conditions (e.g. in hyperinflationary economies where prices of labour, materials and overheads change rapidly), standards become out of date quickly. They therefore lose their control and motivational effects.
4. **Hard to Understand** Some standard costing systems are overly elaborate and are therefore not well understood by line managers and employees. This makes their implementation difficult.