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Accounting and Finance for Managers

1. a) What do you understand by capitalization of earning? How is the value of a firm ascertained with the help of its earnings? Explain with an example.

Answer. Capitalization of earning is actually an income-valuation technique which establishes the worth of a business/company/enterprise by exploring the present benefit of realizing a cash-flow now, as opposed to in the future. The capitalization of earnings is extremely helpful when the potential earnings could be forecasted effortlessly and accurately.

Example

Dr. and Mrs. Nehorayoff divorced. He owned a half-interest in a closely held medical practice, which interest earned at least \$50,000 annually, over and above a reasonable salary. In an equitable distribution proceeding, how would the court determine the value of the business by capitalizing earnings?

The court considered, among other things, the earnings record and the risk involved -- each reflecting an assessment of the business -- to "capitalize" the earnings figure. Rev. Rul. 59-60 § 6. In making these judgments, expert testimony was essential, and the court considered the expert's reason for adopting a particular earnings stream and choosing the multiplier.

Based upon the nature of this enterprise, its history and prospects and "all the facts and circumstances of this case" -- judges fudge, too -- the court looked at actual earnings to impute future earnings and then said the appropriate capitalization factor would be in the range of 3 to 4 (a discount rate of 25% - 33%). From this the court concluded the value of Dr. Nehorayoff's interest in the business using capitalization of net earnings to be \$200,000.

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Explain the important determinants of the Working Capital needs of a firm.

Can two firms with different Working Capital achieve the same amount of sales? If so, explain how?

Answer. The following factors determine a firm's working capital requirements :

Nature of business: Working Capital requirements are basically influenced by the nature of business of the firm. Trading organisations are forced to carry large stocks of finished goods, accounts receivables and accounts payables. Public utilities require lesser investment in working capital.

Size of business operation: Size is measured in terms of a scales of operations. A firm with large scale of operation normally requires more working capital than a firm with a low scale of operation.

Manufacturing cycle: Capital intensive industries with longer manufacturing process will have higher requirements of working capital because of the need to run their sophisticated and long production process.

Products policy: Production schedule of a firm influences the investments in inventories. A firm, exposed to seasonal changes in demand when following a steady production policy will have to face the costs and risks associated with inventory accumulation during the off-season periods. On the other hand a firm with a variable production policy will be facing different dimensions of management of working capital. Such a firm has to effectively handle the problem of production planning and control associated with utilisation of installed plant capacity under conditions of varying volumes of production of products of seasonal demand.

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Volume of sales: There is a positive direct correlation between the volume of sales and the size of working capital of a firm.

Price level changes: Inflation affects the working capital levels in a firm. To maintain the operating efficiency under an inflationary set up, a firm should examine the maintenance of working capital position under constant price level. The financial capital maintenance demands a firm to maintain higher amount of working capital keeping pace with rising price levels. Under inflationary conditions same levels of inventory will require increased investment. The ability of a firm to revise its products prices with rising price levels will decide the additional investment to be made to maintain the working capital intact.

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Discuss the concept and significance of 'Budgetary Control'. Explain briefly different types of budgets that are prepared in a business organization.

Answer. There are a number of advantages to budgeting and budgetary control:

Compels management to think about the future, which is probably the most important feature of a budgetary planning and control system. Forces management to look ahead, to set out detailed plans for achieving the targets for each department, operation and (ideally) each manager, to anticipate and give the organisation purpose and direction.

Promotes coordination and communication.

Clearly defines areas of responsibility. Requires managers of budget centres to be made responsible for the achievement of budget targets for the operations under their personal control.

Provides a basis for performance appraisal (variance analysis). A budget is basically a yardstick against which actual performance is measured and assessed. Control is provided by comparisons of actual results against budget plan. Departures from budget can then be investigated and the reasons for the differences can be divided into controllable and non-controllable factors.

- Enables remedial action to be taken as variances emerge.
- Motivates employees by participating in the setting of budgets.
- Improves the allocation of scarce resources.
- Economises management time by using the management by exception principle.

BUDGET TYPES

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Master Budget

A master budget is an overall financial and operating plan for a forthcoming calendar or fiscal year. It is usually prepared annually or quarterly. The master budget is really a number of subbudgets tied together to summarize the planned activities of the business. The format of the master budget depends on the size and nature of the business.

Operating and Financial Budgets

The operating budget deals with the costs for merchandise or services produced. The financial budget examines the expected assets, liabilities, and stockholders' equity of the business. It is needed to see the company's financial health.

Cash Budget

The cash budget is for cash planning and control. It presents expected cash inflow and outflow for a designated time period. The cash budget helps management keep cash balances in reasonable relationship to its needs and aids in avoiding idle cash and possible cash shortages. The cash budget typically consists of four major sections:

1. Receipts section, which is the beginning cash balance, cash collections from customers, and other receipts
2. Disbursement section, comprised of all cash payments made by purpose
3. Cash surplus or deficit section, showing the difference between cash receipts and cash payments
4. Financing section, providing a detailed account of the borrowings and repayments expected during the period

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Sales budget: this involves a realistic sales forecast. This is prepared in units of each product and also in sales value. Methods of sales forecasting include:

- sales force opinions
- market research
- statistical methods (correlation analysis and examination of trends)
- mathematical models.

Production budget: expressed in quantitative terms only and is geared to the sales budget. The production manager's duties include:

- analysis of plant utilisation
- work-in-progress budgets.

If requirements exceed capacity he may:

- subcontract
- plan for overtime
- introduce shift work
- hire or buy additional machinery
- The materials purchases budget's both quantitative and financial.

c) Raw materials and purchasing budget:

- The materials usage budget is in quantities.
- The materials purchases budget is both quantitative and financial.

Factors influencing a) and b) include:

- production requirements
- planning stock levels
- storage space
- trends of material prices.

d) Labour budget: is both quantitative and financial. This is influenced by:

- production requirements
- man-hours available

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- grades of labour required
- wage rates (union agreements)
- the need for incentives.

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