Understand financial concepts used to inform management decisions accounting essa...

[Business](), [Accounting]()

INTRODUCTION

In every business money is require in order to achieve objectives. Financial decision must have been made carefully, and there should have enough money for the project. Financial management is a necessary tool for supporting the organisation's goals and objectives. Its purpose is to provide information that assists program managers to make the organisation's short- and long-term plan a reality. Financial management involves controlling, conserving, allocating, and investing the organisation's resources, including personnel, equipment, and supplies. Financial activities of the organisation is one of the most important and complex activities of the organisation. Therefore in order to take care of these activities, the person in charge should maintain and ensure that the funds are utilised in the most efficient manner because it will affect the profitability, growth and good will of the organisation. Analytical tools or techniques are important in decision making, analysis, planning and control. Aspects of financial management are performed by most managers today, and it is important that managers be able to apply analytical techniques to their specific financial problems or decisions. The first section of this assignment discusses the financial concepts associated with financial management. This explained the differences between capital and revenue expenditure, how costs are classified and allocated. Examples were given for easy understanding of the terminology. The second part of this assignment is about making a financial case using financial evaluation techniques such as payback, discounted cash flow, net present value, and profit and loss analysis.

UNDERSTAND FINANCIAL CONCEPTS USED TO INFORM MANAGEMENT DECISIONS.

Explain the differences between capital and revenue expenditure, using examples.

Starting up a business involves a smart decision and it is necessary to understand different terminology associated with financial management in order to run the business appropriately. Capital expenditure is money invested by a company to acquire or upgrade fixed, physical, non consumable assets, such as buildings, machinery and equipment or a new business. (Margaret Rouse, December 2011). Assets acquired by incurring these expenditures are utilized by the business for a long time and thereby they earn revenue. Capital expenditure also incurred for the purpose of increasing profit earning capacity or reducing cost production. Sometimes this expenditure even not resulting in the increase of profit earning capacity but acquires an asset comparatively permanent in nature. Revenue expenditures are expenditures which are incurred in the day to day conduct and administration of a business and the effect-of which is completely exhausted within the current accounting year. These expenditures are also known as " expenses or expired costs." E. g. purchase of goods, salaries paid, postages, rent, travelling expenses, stationery purchased, wages paid on goods purchased etc. It also includes the expenditure incurred for the purchase of raw material and stores required for manufacturing saleable goods and the expenditure incurred to maintain the fixed assets in working condition i. e. repair of machinery, building, furniture etc. (accountingexplanation. com, 2011)The difference between capital and revenue expenditures is listed below. (Adapted from Accounting4management. com, 2012)Capital ExpendituresRevenue Expenditures1 Its effect is long term i. e., it is not exhausted within the current account year. Its effect is reduces gradually. 2 An asset is acquired or the value of an asset is increased as a result of this expenditure. 3 It does not occur again and again – it is non-recurring and irregular. 4 Generally, it has physical existence i. e., it can be seen with eyes. 5 This expenditure improves the position of the concern. 6 A portion of this expenditure is shown in the trading and profit and loss account or income and expenditure account as depreciation. 7 It appears in balance sheet until its benefit is fully exhausted. 8 it does not reduce the revenue of the concern. Purchase of fixed assets does not affect revenue. 1 Its effect is temporary, i. e., it is exhausted within the current accounting year. 2 Neither an asset is acquired nor value of an asset is increased. 3 It occurs repeatedly – it is recurring and regular. 4 It has no physical existence, i. e., it cannot be seen with eyes. 5 This expenditure helps to maintain the concern. 6 The whole amount of thisexpenditure is shown in trading and profit and loss account or income and expense account. But deferred revenue expenditure and prepaid expenses are not shown7 It does not appear in balance sheet. Deferred revenue expenditure, outstanding expenses and prepaid expenses, however, temporarily shown in the balance sheet. 8 It reduces revenue. Payment. Payment of salaries to employees decreases revenue. Expenditure is separated into two categories, the capital expenditure and revenue expenditure. As mention above capital expenditure is a fixed asset used to run the business and its effect is long term. Examples in the nursing home are the building or the home itself, equipments like hoist, lifting aids, beds, and machinery such as CCTV camera, computer, heaters, etc. Revenue expenditures incurred by maintaining assets in proper working order like repair and maintenance of machinery and equipments, fittings. It also incurred in meeting day to day expenses of the organisation such as staff salaries, training and courses, uniforms, rent, taxes, telephone, etc.

Explain how costs are classified, using examples.

Within any business, whether it manufactures product or provide service cost classification is essential to help the management run the business better and maintain its budget by allocating certain amount to specific area in the organisation. Costs can be classified as direct or indirect costs. Direct Costs are costs that can be easily traced to a particular object such as a product, the raw materials used to manufacture a product, or the labour associated with the work to produce the product. (Rosemary Peavler, 2012). In the care setting which is a service organisation if one staff in one unit cancelled her/his shift they will call agency to replace so agency staff salary is a direct cost. Other direct costs are materials and supplies such as chemicals, glassware, and research supplies, travel, equipment, express mails and subcontracts, catering, clinical refuse collection, physiotherapy and Clients services. Indirect Costs are costs which affect the entire company, not just on product. They are costs like advertising, depreciation, general supplies for the organisation accounting services, etc. They are services, and costs, for the entire company, not just one product. Indirect costs are usually called overhead. Overhead is the ongoing cost of operating a business that can't be associated with just one product or service. (Rosemary Peavler, 2012). These overheads include indirect labour, staff salaries, vehicles (when rented), electricity, insurance, rent and rates. Other indirect costs are staff recruitment, repairs and maintenance, uniforms, training and courses, and equipment rental, Cost Classification refers to the separation of costs into categories for proper preparation of financial statements or for use in decision making models. To understand classification of cost I listed it in the table below with definition and examples classified as direct and indirect.

Direct

Indirect

Capital Cost is money provided by shareholders, banks or government for the purpose of buying long-term assets of the organisation. (Kent Learning Resources, 2008)Example: buildings, machines like hoist, vehicles, beds, equipment like computer, photocopier, and heaters. Working Capital is the amount of capital needed for running the organisation. (Kent Learning Resources, 2008)Example: money needed to pay recurrent cost such as labour, salaries of contracted / permanent staff. Recurrent Costs are costs that need to be met regularly. They are sometimes called running or operating costs. (Asksource. info, 2012)Example: Staff costs (salaries, training), building maintenance, electricity and water rates, pads, wipes and gloves. Material Costs are the costs of the raw material that go into a product or service. Example: materials from which the finished product is made like in the care setting wipes, pads and gloves are use to provide service to the Clients. Labour Costs are cost of wages paid to workers during an accounting period and related taxes and benefits. (businessdictionary. com, 2012)Example: wages paid to the staff involved in providing service such as nurses, carers, doctors, manager, etc. Expenses an expense or service that is part of the manufacturing process or providing service. (Kent Leaning Resources, 2008)Example: expenses which can be attributed to units of production like special items bought in for particular product. Example: Bank staff, repair service, plumberExample: Cleaning materials, toilet papers, producing health learning materials, information packs, postage, and computer supplies such as paper, toner, and disk. Example: other materials used in the care setting such cleaning materials, toiletries and lubricantExample: wages and salaries paid to those who are not directly involved in providing service such as the supervisors, maintenance staff, domestic, administrator, etc. Example: other expenses, such as rent, rates, telephone, lighting, heating, which cannot be attributed directly to production. Costs can also be classified into different categories depending upon the purpose for which information is required. This can be classified into fixed costs and variable costs. Fixed costs are cost that does not change with an increase or decrease in the amount of goods or services produced. Fixed costs are expenses that have to be paid by the organisation. An example of fixed cost is the rent paid for the property, staff and administration salaries, insurance charges, depreciation, and marketing cost. Variable costs are those costs that vary depending on a company’s production volume. Variable costs can include direct labour (wages), and direct material (raw material)

Explain how costs are allocated, using examples.

Cost allocation is the process of identifying and assigning the costs of services necessary for the operation of a business. (wisegeek. com, 2012). It is important to be able to create an operating budget allowances and allocations based on the priorities of the organisation. It can be seen as a tool that helps track all costs associated with the ongoing operation more efficiently. It also helps to provide focus and structure to financial planning in a way that it would identify properly the assigned costs; they rise as production increases and fall as production decreases. Example of cost allocation would be the salary of a staff working in a specific unit. In a nursing home the staff is assigned to a specific unit, however, if the staff moves to fill in another unit the salary for the entire shift is allocated to the unit the staff worked, instead of permanent unit.

Costing Systems

Costing system is a manner of monitoring expenditures and part of a broader system of accounting deployed in the business environment. These are used for structuring and pricing a product, or for naming the price for a service that is provided by the organisation. Costing system help in monitoring input costs, raw material cost, labour costs, taxes, levies and other costs involved in the production cycle of a product. These techniques are also useful in determining input costs for providing services in a service industry. (howtodothings. com, 2012). Some of the better techniques in costing system are discussed below. Job Costing is the process of tracking the expenses incurred on a job against the revenue produced by that job. Job costing is an important tool that enables to track a number of factors and analyze the results to aid decision making. It allows identify the most and least profitable areas of the business, so that you can focus on the profitable elements, and try to make the less profitable aspects more efficient. It also helps to quote new jobs more accurately, and assist in managing jobs in progress. For example, building contractors, subcontractors, architects and consultants often use job costing. (Stan Snyder, 2008)Process Costing is a method of costing used mainly in manufacturing where units are continuously mass-produced through one or more processes. Refineries, paper mills, and food processing companies are examples of businesses which use process costing. In process costing it is the process that is costed (unlike job costing where each job is costed separately). The method used is to take the total cost of the process and average it over the units of production. (accaglobal. com, June 2011). Product Costing is the process of assigning costs to inventory and production based on expenses that go into producing or buying inventory. It is an especially important process for manufacturers, and there are several potential costing methods that businesses choose for their simplicity, accuracy or other factors. If a business contracts out accounting services, the accounting firm may offer in-depth product costing analysis as part of its service. (Tyler Lacoma, 2012). Examples are materials, supplies and equipment. Activity Based Costing (ABC) is a method of assigning cost to products or services based on the resources that they consume. Its aim is to change the way in which costs are counted. (The Economist, 2012). Example of this is the detailed analysis of the electricity bill, it will determine the causes of its cost so that they may be allocated to a cost centre. In this way overheads are more accurately absorbed. This leads in turn to more accurate measures of performance. ABC is a unique approach to controlling costs by providing a mechanism for being able to track all related costs, as well as time associated with any operation or activity.

Budgetary Control and Variance Analysis

Budgetary Control

Every organisation have main objective to maximise the profits and to maximise the cost. They cannot run properly without a good budgetary system. Budgetary control system is very helpful in bringing economy in business. Budgetary control is applied to a system of management and accounting control by which all the operations and output are forecasted in a proper manner to achieve the best possible profits. Budgetary Control is important in establishing budgets and revising budgets, to execute responsibilities in order to perform the specific tasks to attain the objectives. It is also essential in continuing comparison of actual performance with standard performance and taking corrective actions if there is any deviation. (slideshare. net, 2010).

Variance Analysis

Variance analysis is used as an effective method of monitoring budgets. A variance is the difference between an actual amount and the expected amount of costs and revenues. It is essential to identify any variances from the budget and to understand the nature of the variance, and its cause, to ensure that any corrective action is effective and not superficial or short term. This will assist managers in determining what may have gone right or wrong and to help in future decision –making. The process of variance analysis is a key activity in budgetary control. Identifying whether variances are adverse or favourable and whether or not they are significant is an important management activity. (Kent Learning Resources, 2008)The principle is that where there is no variance, or an insignificant variance, from budget, and then there is no need to take any action because the actual results are similar to the planned result. This principle is known as management by exception and concentrates management activity where it is needed.

BE ABLE TO MAKE A FINANCIAL CASE TO INFORM A MANAGEMENT DECISION.

Use range of financial evaluation techniques to inform a management decision.

An investment appraisal is a technique whereby the need for the decision and options are identified and the merits and drawbacks of each option are analysed and identified preferred course of actionThe most common techniques for assessing financial viability are the payback, discounted cash flow, net present value (NPV), and internal rate of return (IRR) methods. These methods are based on cash flow forecasts. Payback is the simplest method of investment appraisal and a more popular technique for evaluating capital investment decisions in the payback period method. It compares the cash out of the initial investment with annual cash net inflows (or savings) that are generated by the investment. It also calculates the time (normally years) that is taken for the opportunity to pay back the initial outlay.

Discounted Cash Flow is the technique which takes account of the time value of money. It can be used to compare the return form proposed projects, with the returns that would be expected if the money invested in a bank. The rate of interest earned had the money invested in this way, the opportunity cost, is known as the test discount rate. It is also use by most organisations for evaluating investments. (Kent Learning Resources 2007)Net Pressure Value is the primary measure to be used as it measures the profitability of project relation to a test discount rate that will ensure an adequate return to the business to cover opportunity costs. (Kent Learning Resources 2007)Profit and Loss analysis is use to know how the revenue of a business is turned into the net income of a business. It will help the organisation to understand their net income, which is also helpful in decision-making processes. For example, in our nursing home there is enough profit to expand or make additional services and there is month that not gaining any profit so the management have to review their financial status. To identify, measure, and analyse the financial performance of the organisation investment appraisal was done. Some evaluation techniques used are shown on the table, pie chart, line and bar graph below.

TABLE 1

SUMMARY

TOTAL

OPENING BALANCE

£2, 105, 156. 00

CLOSING BALANCE

£1, 704, 560. 00

PROFIT/LOSS

£400, 596. 00

The figures shown in table 1 are the cash flow in and cash flow out of a nursing home. This nursing home has 82 bed capacities, every month there are number of occupancy with the average fees per week of £655 per resident/client. The cash flow in is coming from the total income which the client paid per month and cash flow out are those expenses they spent to run the business. Cash flow out categorized as direct and indirect expenses which is explained at the previous part of this assignment. In the table also shown expenditures total budget for the whole year, wherein some of the expenses go beyond the allocated budget specifically in repairs and maintenance, non contract medical, staff recruitment, telephone bills, crockery and linen with the total variance of £49, 461. 00. As a summary subtracting the closing balance (total expenses for the year) from the opening balance (payments by the clients' for the year) the organisation gets the profit, and from profit-and-loss account, cash flow statement for 2010 declare. TABLE 2

CASHFLOW

MONTH

CASHFLOW IN

CASHFLOW OUT

JANUARY£196, 500. 00£166, 800. 00FEBRUARY£191, 260. 00£138, 793. 00MARCH£193, 880. 00£138, 958. 00APRIL£183, 400. 00£148, 435. 00MAY£172, 920. 00£139, 620. 00JUNE£142, 776. 00£165, 324. 00JULY£157, 200. 00£125, 370. 00AUGUST£167, 680. 00£137, 499. 00SEPTEMBER£165, 060. 00£135, 237. 00OCTOBER£172, 920. 00£132, 702. 00NOVEMBER£178, 160. 00£139, 359. 00DECEMBER£183, 400. 00£136, 463. 00

TOTAL

£2, 105, 156. 00

£1, 704, 560. 00

LINE GRAPH REPRESENTATION OF CASH FLOW IN AND OUT FOR CALENDAR YEAR 2010

The figures shown in table 2 are the monthly cash flow in and cash flow out for calendar year 2010. There is income deflation in the middle of the year due to lower number of occupancy in the nursing home; the cash flow out is higher so there is a loss of around 16% on that month. As shown in the bar graph below other months are gaining profits in which help run the organisation for the succeeding months of the year.

Bar Graph Representation of Profit and Loss for Calendar Year 2010

Expenses are the amount spent by the organisation to run the business. The figures shown in the table below are the direct expenses for the calendar year 2010. The Nursing Home spent more on staff wages and NIC which is 90% of the direct expense while 6% goes to catering services such as food, utensils and etc., the remaining 4% of the budget use for paying rent, non contract medical, clinical refuse collection and physiotherapy and patient services. TABLE 3

DIRECT EXPENSES FOR A YEAR

RENT AND RATES£10, 800. 00WAGES & NIC£1, 305, 957CATERING£86, 301. 00NON CONTRACT MEDICAL£29, 376. 00CLINICAL REFUSE COLLECTION£11, 875. 00PHYSIOTHERAPY AND PATIENT SERVICES£9, 891. 00

TOTAL DIRECT EXPENSES

£1, 454, 200. 00

Pie Chart Representation of Direct Expenses for Calendar Year 2010

The table 4 represents the indirect costs spent for the same calendar year. As shown on the pie chart repair and maintenance has the highest costs the organisation spends on. They also spent more on light and heat which is at 13% part of the budget while they spend less on uniforms. TABLE 4

INDIRECT COST FOR A YEAR

LIGHT AND HEAT£31, 727. 00TELEPHONE£20, 877. 00PRINTING POSTAGE & STATIONERY£9, 823. 00STAFF RECRUITMENT£7, 593. 00REPAIRS AND MAINTENANCE£158, 316. 00CROCKERY & LINEN£7, 194. 00UNIFORMS£333. 00TRAINING & COURSES£14, 497. 00

TOTAL INDIRECT COSTS

£250, 360. 00

Pie Chart Representation of Indirect Costs for Calendar Year 2010

CONCLUSION

Part of the business success, managers must know and understand the basic financial concepts such as correct distribution of budget, balance or determine when and how business is turning a profit. By gaining an understanding of this financial concepts business will manage efficiently and good course of action and decision on financial management is viable. Managers can also use number of tools or techniques to assist financial planning, control and decision-making. Investment Appraisal is also important in analysing and identifying financial performance of the company.