12. FINANCIAL MANAGEMENT

Financing the business

The capital of a business consists of those funds used to start and run the business. Capital may be of two types: fixed and working.

Fixed capital refers to items bought once and used for a long period of time. This includes such things as land building, fixtures and equipment.

Working capital is the type of funds, which is needed for carrying out day to day operations of the business smoothly. The management of working capital is no less important than the management of 'long term ' financial investment.

Working Capital Management

Significance of working capital

Every running business needs working capital. Even a business which is fully equipped with all types of fixed assets required is sure to fail without I) adequate supply of raw materials for processing, ii) cash to pay wages, power and other costs, iii) creating a stock of finished goods to feed the market demand continuously and iv) the ability to grant credit to customers. All these require working capital. Thus working capital is the lifeblood of a business without which a business will be unable to function. No business will be able to carry on day to day activities without adequate working capital.

Components of working capital

The working capital has following components, which are in several forms of current assets. The basis for assigning value to each component is shown against each.

Components of working capital	Basis of valuation
Stock of cash	Purchase cost of raw materials
Stock of raw materials	Prime cost
Stock of finished goods	Cost of production
Value of debtors	Cost of sales or sale value
Miscellaneous current assets like short term investment loans and advances etc	Working expenses

Each constituent of the working capital is valued on the basis of valuation enumerated above of the holding period estimated. The total of all such valuation becomes the total estimated working capital requirement.

Factors influencing working capital requirement

The important factors that influence the working capital requirements of business are furnished below.

1. Nature of business
2. Seasonality of operations
3. Production policy
4. Market condition
5. Conditions of supply
6. Growth and expansion
7. Price level changes
8. Manufacturing cycle

Accurate calculation of working capital

The working capital has very close relationship with day to day operations of a business. Neglecting proper assessment of working capital can therefore affect the day to day operations severely. It may lead to cash crisis and ultimately to liquidation. Inaccurate assessment of working capital may cause either under assessment or over assessment of working capital and both of them are dangerous.

Consequences of under assessment of working capital

1) Growth may be stunted. It may become difficult for the firm to undertake profitable projects due to non-availability of working capital.
2) Cash crisis may emerge due to paucity of funds.
3) Optimum capacity utilization of fixed assets may not be achieved due to non-availability of working capital.
4) The business may fail to honour its commitment in time there by adversely affecting its credibility. This situation may lead to business closure.
5) The business may be compelled to buy raw materials on credit and self finished goods on cash. In the process, it may end up increasing cost of purchases and reducing selling prices by offering discounts. Both these situations would affect profitability adversely.
6) Non-availability of stocks due to non-availability of funds may result into production stoppage.

While inadequate working capital has disastrous implications on the business, excessive working capital also has its own dangers.

Consequences of over assessment of working capital

1) Excess of working capital may result into unnecessary accumulation of inventories.
2) It may lead to excessively liberal credit items to buyers and very poor recovery system and cash management.
3) It may take management complacent leading to its inefficiency
4) The over investment in working capital makes the capital less productive and may reduce return on investment.

Planning financial needs

Planning the financial needs of a business is very important. The owner or manager needs to be able to ask the following questions.

Why do I need the money?

The general area of need for money is: (a) starting a new business, (b) inventory, (c) expansion, (d) remodeling, and (e) improving working capital.

How much money will I need?

It is important to be able to specify how much money you will need. It is advisable when doing any financing to be able to stipulate the amount of money that you will be using and to specify if it is to purchase inventory, pay salaries or wages or even to be used to purchase a new equipment.

When I will be able to repay the money?

Friends, bankers, and business associates are always interested in knowing when and how you anticipate repaying the loans. The majority of loan repayments come from sales of merchandise, inventory and payments received for services rendered.

Factors that increase loan repayments

		Amount borrowed increases
Amount of payments	Increases when	No. of years of loan increases
		Interest rate increases

Where will I obtain money?

Compare the advantages and disadvantages of obtaining money from different sources in terms of interest payment and control over business.

Sourcing of capital for business

There are two major forms of financing any business; equity financing and debt financing.

Equity capital (ownership) may come from personal savings, from partnership or by selling stock in a corporation. Equity financing involves giving up ownership to the investors of the business. It also involves dividing of the business ownership among the various investors. That is instead of repaying an investor or one is giving money to the business, the investor now becomes an owner and receives money from business primarily through dividend or profit sharing system.

1. Common stock. This is the most widely used form of equity financing, and provides the greatest potential return on investment for the investor. It is important to remember that if the firm does fail, all of the creditors, and investors would be repaid before the common stockholders are repaid.

2. Preferred stock. It provides a preference for stock holders during failure or bankruptcy. Preferred stockholders must be paid in full before other common stockholders are repaid. Because of this preferential treatment, the preferred stockholders receive smaller dividends or returns on investment than do common stockholders; therefore, convertible preferred stock may be used, allowing the investors to convert their preferred stock at any time in the company's future.

3. Convertible debentures. This is a long-term debt that would be paid off by an investor, with the option of the investor to convert the debentures to common stock before being repaid.

4. Debt warranties are similar to convertible debentures but would allow the investor or creditor the option to purchase a specified stock at a specific set price. This option to purchase is available to the investor or creditor, even after the debt has been repaid but before the warranty has expired.. This generally provides a longer time period for investment (ownership) for one providing debt financing to a corporation. Thai is, the debt warranty would allow someone loaning money to a business the opportunity to own part of the business even after the debt has been repaid until the time when the warranty expires.

Both debentures and debt warranties are debts and, therefore, must be paid before either common stockholders or preferred stockholders are paid in case the business fails. All four of these opportunities are good opportunities to invest in business and provide potential ownership to investors who are interested in that specific business.

Venture capital has become an increasing source of equity funds for new business ventures. Venture capital individuals or firms supply funds for a percentage ownership of the new business. This source of capital has been popular in business start-ups involving new technology.

Source of debt capital are commercial banks, co-operative banks, mutual funds, vendors, equipment manufacturers and distributors, factors, private investors, special type of finance lending institutions.

Commercial banks in India include State Bank of India and its Associate Banks, all nationalised banks and private commercial banks. Many of the commercial banks have industries branches. They provide both fixed capital and working capital with over draft facility.

Special financial institutions like

Industrial Development Bank of India

Tamil Nadu Industrial Investment Corporation

Small Industries Development Bank of India

Mutual Funds

National Bank for Agricultural And rural Development

Co-operative banks

Industrial Credit Investment and Investment Corporation of India

National Agricultural Marketing Federation of India

Export-Import Bank (Exim bank)

Vendors can be an important source of short – term credit for small business firms. Firms that sell inventories to a business usually will finance the purchase of these goods for short periods of time, usually 30 to 90 days.

Factors are financial firms that finance accounts receivable for business firms. They may either purchase or discount accounts receivable. If they discount accounts receivable, they function exactly as the commercial bank. When factors purchase accounts receivable, they make an analysis of the receipt of the accounts and pay the business firm a percentage of the total amount.

Documents required to apply for loan

Bankers generally look for three things when considering a loan application : (1) ability to repay the loan, (2) collateral, and (3) record. The small business entrepreneur should take along three recent financial statements when applying for a loan or a line of credit : (1) a balance sheet, (2) an income statement, and (3) a cash flow statement.

Collateral refers to the personal or business possessions an owner is willing to assign to the lender as a contract for debt repayment . If the borrower does not repay the debt, all collateral remits to the lender to repay the loan.

Financial Analysis

Financial analysis is one of the roots of management used to carry out its controlling function. Proper interpretation of data presented by the financial statement helps in judging the profitability of operations during given time periods, in determining the soundness of financial condition at a specific date, in determining the soundness of financial condition at a specified date, in determining future potential to meet existing or anticipated credit obligations and in developing performance trends to be used as a basis for future decision making. The term financial statement refers to two basic statements that an accountant prepares at the end of a specified period of time for a business enterprise.

1) Balance sheet: It is a statement of financial position of a firm at a particular point of time.
2) Income statement: It is also called profit-loss statement. It shows firm's earnings for the period covered, usually half yearly or yearly.

Balance Sheet

From an analyst point of view, it is a written representation of resources and liabilities of the business firm. It shows the financial condition of the business firm at a given date. The balance sheet contains and reports on assets, liabilities and net worth of a firm. Assets must always equal the sum of liabilities and net worth. What is owned by or owed to firm (assets) must equal what the firm owes to its creditors plus what is owed to its owners (net worth). Balance sheet indicates the sources from which business obtained capital for its operations and the form in which that capital is invested on a specific date. **Net worth** represents owner's equity in the business.

Limitation : It is an interim statement between two operating periods. It summarizes solvency of business at a given time rather than financial transactions occurred in business during an accounting period.

Balance Sheet of Ramakanth as on 31.12.2002.

How beneficial to owners?

- It determines the safety of their investments.
- The probability of additional capital requirements.
- Possibility of withdrawals or dividends.
- Need for reorganization or liquidation.

Assets			Liabilities		
No.	**Current Assets**	**Rs.**	**No.**	**Current Liabilities**	**Rs.**
1.	Bank Balance	30,000	16.	Operating loan payment	15,000
2.	Cash on hand	300	17.	Forthcoming principal due on long term loan	3,000
3.	Accounts receivables	800			
4.	Cocoon for sale	5000			
5.	Crops & supplies	3000			
	Total current Assets	39,100	18.	Total current liabilities	18,000
	Intermediate Assets			**Intermediate liabilities**	
6.	Bullock pair	6,000	19.	Balance of sheep loan	7,000
7.	Milch Animal	3,000			
8.	Oil engine	7,000			
9.	Bullock cart	4,000			
	Total intermediate Assets	20,000	20.	Total interm. liabilities	7,000
	Long term Assets			**Long term Liabilities**	
10.	Land Dry land 10 Ac	80,000	21.	Mortgage of land	25,000
11.	Garden land 3 Ac	60,000			
12.	Wet land ½ Ac	15,000			
13.	Mango garden	25,000	22.	Total long term liabilities	50,000
14.	Total long term Assets	1,80,000	23.	Net Worth	1,89,100
15.	Total Assets	2,39,100	24.	Total liabilities	2,39,000

How useful to creditors?

- Help in determining the involved in granting credit.
- How much money safely be granted.

How helpful to management?

- Helps to judge the results of its operating activities and in planning for proper financing of future operations.

2. Income Statement

It is also called profit and loss statement. It states the source of firm's incomes, describes the nature of the expenses, and shows the net profit earned (or net loss incurred) during an accounting period. It is supporting evidence to balance sheet, in the sense, that it explains the change in retained earnings on the balance sheet.

Uses of Income Statement

- Can determine what profit is earned by the business.
- Can find particular causes of low profit or operating losses.
- Management can take action to prevent the occurrences of future losses or to prevent further decline in profits

Comparison of balance sheet and income statement

No.	Balance sheet or Net worth statement	Income statement or profit or loss statement
1.	Net worth statement is a summary of assets, liabilities and owner's equity at a given point of time.	Income statement is a summary of both cash and non cash financial transactions of farm business accrued during the selected accounting period
2.	The most commonly requested document by a lender in reviewing a loan request.	It is used to measure the financial profitability of business during a period of time.
3	It is used in preparation of income statement and tax returns	It is used in making an analysis of the business profitability, efficiency and financial stability.
4.	Net worth statement offers a little insight into financial transactions of accrued in business during an accounting period.	Information from this document is used in preparation of cash flow summary.

Cash flow statement

The cash flow statement is a measure of changes in cash the business has on hand from month to month. It records or projects all cash receipts less all cash disbursements. A business may use the cash flow statement as a record of what has occurred to cash or as a projection into the future to determine future needs for cash or as both.

The cash flow statement is accurate when it is a record of past receipts and disbursements and an estimate when it is projected for future months. The cash flow statement is usually calculated on a monthly basis for an entire year.

Profit and Loss Statement of Farm B for the period Jan 1, 2001 to Dec 31,2002.

S. No.	Particulars	Amount in Rs.		
	INCOME			
	Cash Receipts			
1.	Paddy sales 30 qtl.	7,500		
2.	Sugarcane sales 16 tonnes	5,500		
3.	Groundnut sales 20 qtl.	12,000		
4.	Milk sale 100 ltr.	3,800		
5.	Broiler sales 200 birds	10,500		
6.	Miscellaneous income	1,500		
7.	Total cash receipts		40,800	
	Net Capital gains Income			
8.	Sale of purchased milch animal	2,000		
9.	Home bred animal sale	2,000		
10.	Machinery sale	150		
11.	Total net capital gains		4,150	
	Changes in Inventory Value			
12.	Crops in inventory	6,000		
13.	Livestock in inventory	-1,000		
14.	Total changes in inventory value		5,000	
15.	Gross farm income			49,950
	EXPENSES			
	Operating expenses			
16.	Hired labour	3,000		
17.	Hired bullock labour	4,000		
18.	Machinery, fuel, repairs	2,500		
19.	Fertilizers	500		
20.	Other crop expenses	1,400		
21.	Livestock, machinery, veterinary and marketing expenses	1,000		
22.	Interest on current debts	600		
23.	Miscellaneous expenses	700		
24.	Total operating expenses		13,700	
25.	**Fixed Expenses**			

	Land rent	3,000		
26.	Land revenue	500		
27.	Improvement repairs	4,200		
28.	Interest on intermediate and long term loans	1,000		
29.	Equipment depreciation	1,500		
30	Livestock depreciation	1,000		
31.	Attached farm servants wages	1,000		
32.	Depreciation on buildings, improvements	600		
33.	Total fixed expenses		12,800	
34.	Total expenses			26,500
35.	Net farm income			23,450

Financial Tests

Ratio analysis: It has the following advantages

- Has no units
- Compares numerator with respect to denominator
- Relative and comparable

Ratio analysis will explain what strength, weakness, pressures and forces are currently at work in your business operation farm business managers will need a full time job accountant for the change accruing in his capital structure and net worth as revealed in his balance sheet.

Ratio analysis of properly calculated rates can be readily compared with i) firm's past ratio in order to show trends, ii) ratio of other firms of similar size, large size or of smaller size with which the manager is familiar, iii) industrial standards and iv) projected goals as reflected in plans for the future.

Fundamental difference between ratio analysis and trend is that the ratio analysis measures the movement in absolute terms whereas the trend indicates the relationship. The marginal analysis used in determining the most profitable combination of resources and products. The concern with last added or marginal unit of input and product.

There are three types of financial tests and they are a) tests of liquidity, b) tests of solvency and c) tests of profitability.

a)Tests of liquidity

Tests of liquidity are usually conducted to determine the firm's ability to meet its current financial obligations. The current ratio is the most commonly recognized indicator of a firm's liquidity.

$$\text{i) Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{39{,}100}{18{,}000} = 2.17$$

Nature of current assets determines the value whether the firm is able to meet promptly the current liabilities. The reasonableness of any current ratio can be tested by comparing current ratios of similar firm in the industry.

ii) Acid test ratio (ATR) or quick current ratio

$$\text{ATR} = \frac{\text{Current monetary assets}}{\text{Current liabilities}} = \frac{31{,}100}{18{,}000} = 1.73$$

The difference between current ratio and acid test ratio is the elimination of inventories in current assets used in acid test ratio. If a firm's cash marketable securities and accounts receivable are more than sufficient to meet its current liabilities, then inventories may be viewed as a buffer to absorb any subsequent deficiency in the receivables, such as unexpected bad debt.

iii) The inventory to receivable ratio

$$\frac{\text{Inventory}}{\text{Total receivables}} = \frac{8{,}000}{800} = 10.00$$

It also associated with the acid test ratio. Inventory represents cost items while receivables presumably include profit. Hence, a favourable change in this ratio may be due to the execution of profitability convert its inventory into liquid cash. It also has relevance in identifying a firm's current position in a business cycle since inventory generally is more subject to the value changes than the receivables are.

b)Tests of Solvency

Tests of solvency are designed to measure a firm's ability to meet both interest change and repayment of loans associated with its long-term financial commitments. Tests of solvency tell the manager how well his firm will survive a crisis but will provide little information as to the firm's normal operational viability.

i) Net worth to total debt ratio

$$\frac{\text{Net worth}}{\text{Total liability}} = \frac{1{,}89{,}100}{2{,}39{,}100} = 0.79$$

In general, the larger the net worth to total debt ratio, the less a firm's creditors concern themselves with thoughts of fore closure. It should be noted that some business may attempt to improve their current ratio, though not necessarily their financial health, though a simple funding operation. They decrease their current obligations by increasing long term debt and leave the total debt used by the manager as a valuable supplement to the current ratio. Where a very large proportion of a firm's total debt is funded, a manager may choose to use an auxiliary ratio of net worth to current liabilities, there by emphasizing the relative size of funded debt and its effect on solvency.

ii) Net worth to fixed asset ratio

$$\frac{\text{Net worth}}{\text{Fixed assets}} = \frac{1{,}89{,}100}{1{,}80{,}000} = 1.05$$

This ratio indicates the proportion to the owner's equity invested in fixed assets. The ratio of above one, if it exists, represents the proportion of owner's equity involved in the firm's working capital. A raising net worth to fixed asset ratio indicates that management may be less concerned with insolvency. A declining ratio serves to warn management that the firm possibly may be expanding its physical plant beyond its current ability to support it financially. This would be particularly important to management during a general period of declining business.

c) Tests of Profitability

Two subgroups of financial ratios are generally used by management to test the profitability of a business. The first sub-group involves those ratios that measure profitability of a business. The first sub-

group involves those ratios that measure profitability as related to investment. The second is more concerned with measuring profitability as related to sales. Both sub-groups of ratios are helpful to managers in identifying performance trends over time and/ or comparing profit performance among similar business firms.

i) The earnings to investment ratio

Net income Rs.8,00,000
--------------- = ---------------- = 0.1 (Hypothetical figure)
Net worth Rs. 80,00,000

This ratio is investor oriented and is of particular interest to the stock holders in so far as it has a direct impact on dividends.

ii) The earnings to sales ratio

Net income Rs.8,00,000
---------------- = --------------- = 0.89 (Hypothetical figure)
Sales Rs.90,00,00

This ratio measures profit margin to sales. Higher the ratio, the more profitable the firm is. However, in comparing two or more enterprises, extreme care should be taken that net income excludes depreciation, taxes and outside earnings.