CHAPTER – 3
FINANCIAL MANAGEMENT

Significance

1) Money is the life blood of any business enterprise, as it is required to purchase machines, materials and to pay wages and salaries to employees and to allow credit facilities to customers.
2) It deals with the procurement of money at the time it is needed and its effective utilization in the enterprise.
3) Financial management involves managerial activities concerned with the procurement and utilization of funds for business purpose.
4) Finance manager deals with planning, organizing, directing and controlling financial activities of the enterprise.
5) It also covers other aspects of financing such as assessing the needs of capital, raising sufficient amount of funds, cost of financing, budgeting, maintaining liquidity, lending and borrowing policies, dividend policies etc.
6) The finance manager has to see that funds are properly utilized and they do not remain idle as they involve many costs.
7) Safety, soundness and liquidity are the three principles which should govern the investment of funds.

Objectives of financial management

1. The objective of financial management must be in tune with the over all objective of the enterprise.
2. The main objective of the business enterprise is to earn sufficient profits so as to pay a reasonable rate of return on capital employed, and part is returned to the business to make it a strong enterprise which could bear all the ups and downs in the business.

The main objectives are

1) Ensuring regular and sufficient supply of capital to the business.
2) Ensuring a fair rate of return to the suppliers of capital.
3) Ensuring better utilization of capital by following the principles of liquidity, profitability and safety.
4) Coordinating the activities of finance department with those of other departments of the enterprise.

Functions of financial management

1. Formulation of the objective of the finance department. It should be in tune with the overall objective of the organization. Coordination with other functional managers are to be achieved in this respect.
2. Estimating the financial requirement.
   a) Long term requirement
   b) Short term requirement
   c) Preparation of budget for various activities to estimate the financial requirement.
   d) There should not be either deficiency or surplus of funds.
   e) Insufficient capital will not meet its requirements .Excess capital- management may become extravagant.

3. Determining the structure of capital
    a) The kind and proportion of different securities.
    b) Proper mix of equity and debt
    c) Short term and long term debt

   It depends on cost of raising finance from different sources and period for which funds are required.

4. Procurement of finance
    a) It depends on the capital structure.
    b) Finance can be raised from share holders debenture holders, banks, other financial institutions, public deposits etc.
    c) Cost of finance, charge over the assets, dilution of ownership, duration etc are to be taken in to consideration.

5. Investment decisions : The fund procured by the management are to be invested in various assets so as to optimize the return on investment

   A part of the long term fund has to be invested in working capital.

6. Disposal of surplus : How much to be retained by the company: how much should be distributed as dividend, how much to be transferred to dividend equalization fund, etc are to be decided. These depends on
    i. Earnings of the company
    ii. Market price of the share
    iii. Future expansion
    iv. Cash flow position etc.

3.Management of cash
    a) To maintain liquidity of the company
    b) To pay to creditors
    c) To purchase stock of materials
    d) To pay to labor
    e) To meet day- to- day expenses

       All the departments should get cash in time

       Idle cash is to be minimized

       Shortage of cash should be avoided

       Idle cash should be invested and be able to convert to liquid cash quickly.

       Cash flow statement should be prepared in order to know the need of cash during different periods.

4. Financial control : Evaluation of financial performance such as return on investment, pay back period, internal rate of return, budgetary control, cost control, internal audits, break- even analysis, ratio analysis, evaluation of borrowing and lending policies.

Time value of money

The value of money with respect to time increases. If we invest Rs.100/- now at a rate of 10% we will get Rs.110/- after one year or Rs.121/- after two years. Therefore Rs.100/- now and Rs.100/- after one year are not having the same value. Whenever we talk of money we should mention the time when the transaction is taking place. Rs.100/- now and Rs.110/- after one year or Rs.121/- after two years are

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economically equivalent. Whenever a transaction take place, the time is mentioned as present time. The subsequent transactions take place in future. Every present value will be having an equivalent future value at a rate ‘i’ after ‘n’ years. This can be represented by the compound interest equation.

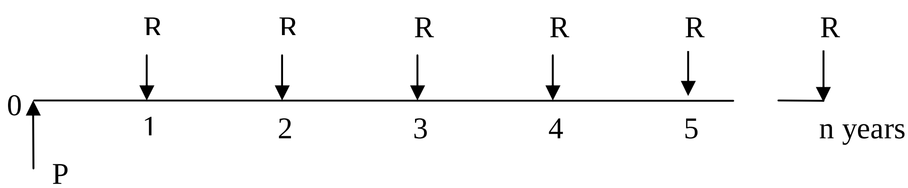
If P – Present value; S – Future value ;
‘ i ‘ – The interest rate n - No. of years
Then **$S = P(1+i)^n$**

Eg: How long will it take to double an amount if invested at 6% per year.

The mode of repayment of a debt consists of a series of uniform equal payments occurring at equal time intervals at the end of each year spread over a period of ‘n’ years.

This mode of payment is called annuity.

If R is the annuity, the cost diagram can be drawn as below.



The present value of annuity is

$$P = \frac{R}{(1+i)} + \frac{R}{(1+i)^2} + \ldots\ldots\ldots\ldots + \frac{R}{(1+i)^n}$$

It is a geometric progression and the sum is given by $P = R \dfrac{(1+i)^n - 1}{i(1+i)^n}$

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Eg: What annual payment for 8 years is equivalent to investing Rs.9000/- now at 6 % interest rate?

Here i = 0.06 n = 8 P = 9000

$$\mathbf{R = P \frac{i(1+i)^n}{(1+i)^n - 1}}$$ Substituting

We get R = Rs. 1449/-

Financial Accounting

Financial accounting is concerned with external transactions. It records all dealings with outside the concern.

It covers

1) Cash accounts – cash receipts and payments
2) Personal accounts – credit given and taken
3) Real accounts – property bought and sold
4) Nominal accounts – expenses incurred

It meets the following objectives

1) Stock exchange requirements
2) Legal requirements
3) Tax requirements
4) Safeguarding share holders
5) Dividend policy

Financial accounting

1) Is a legal necessity
2) Is vital for showing the indebtedness of a concern
3) Serves as evidence of credit worthiness
4) Serves as a report on management's social obligations

Book keeping

As the size of the business grows, no business man can remember all his transactions and thus he releases the necessity of proper book keeping

Proper book keeping show

1. All purchases, sales and returns in the financial year.
2. Quantity and value of goods available with the concern.
3. Transactions with creditors and debtors
4. Information about assets and liabilities of the concern
5. Profit and loss accounts
6. Cash available with the concern
7. The financial soundness of the concern.

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Book keeping may be defined as the art and science of recording all the dealings related to money, goods and services in a systematic manner so that any information pertaining to business can be easily supplied to the management or other interested parties.

System of book keeping

1. Single entry system :
   a) Every transaction is between two persons or two concerns.
   b) Every transaction thus effects two accounts
   c) Single entry system records only one side of the transaction and hence it does not provide complete information about a transaction.
   d) This system of book keeping is not generally used.
2. Double entry system :
   a) It records both sides of the transaction and thus provides complete information of the business transaction.
   e) The two sides of the business transaction are
      i. Credit side and ii. Debit side
   1. The value of the assets will appear on the left hand side and the value of the liability on the right hand side of an account.

Terms used in book keeping

2. Capital is the amount of cash, fixed assets and other goods which one invests in a business.
3. Transaction: The monetary dealing between two persons or two parties.
4. Trade discount: It is a discount or a percentage deduction from the list price which a seller gives to the purchaser.
5. Drawing: It is the withdrawal of money by the owner from his business for his personal use.
6. Sales return: A customer who has purchased certain goods returns some of them (due to some reasons) to the firm.
7. Purchase return: A firm returns to the vendor some of the goods purchased from him due to some reason.
8. Commission: It is a kind of remuneration given by a firm to a person for his services rendered to the firm.
9. Cash trade: It is a cash trade when a person buys and sells goods for cash only
10. Credit trade: It is a credit trade when a person makes both cash and credit sales and purchases.
11. Debtor: One (person or firm) who owes money to others, ie; he has to pay money to others.
12. Creditor: One to whom others owe money; ie; he has to get money from others.
13. Bad debt: A bad debt is one which becomes irrecoverable.
14. Turn over: It implies the total (credit and cash) sales of a business.
15. Assets: The resources of the business enterprise, eg: Properties, equipments, stock, debtors, cash etc.
   It is classified as
      a) Current assets:

i. It includes cash and other assets that can be converted into cash with in a short time frame.

ii. It may be consumed in immediate day-to-day operations of the business.

iii. It includes cash in hand, cash in bank, notes receivable, investment, debtors, accounts receivable, all inventories.

b) Fixed assets:

i. Fixed assets have relatively permanent existence and are not readily converted in to cash.

ii. It is held for the purpose of earning income and are not sold in the course of trading.

iii. Fixed assets include land , building, equipment and machinery, furniture, transport vehicle.

f) Other assets:

Neither fixed assets nor current assets. It includes

i. Intangible assets such as patents, copy rights, franchises, goodwill
ii. Long term investments in the securities of other companies, in sinking funds, pension funds.

15. Liabilities

Those from whom a business enterprise borrows are known as creditors. The creditors have a claim on the business enterprise until they are paid.

These claims are termed liabilities.

Types of liabilities

1. Current liabilities: Debts which are expected to be settled with in one year or less. It includes: bank over draft, short term loans, trade credit, notes payable, wages of employees, unearned revenues ie. Rent or interest received in advance.
2. Fixed liabilities (long term liabilities)

It includes

i. Owners capital
ii. Long term debts
iii. Capital reserves

The journal and ledger

Every business transaction is recorded on the same day in a book called journal. It constitutes the original record of transaction. It records many accounts related to many persons and thus it is very difficult to trace easily the accounts related to one person or firm.

From the journal the transactions related to each person or firm are sorted out, classified and entered in a book called ledger. It is called posting. The ledger is split in to two halves, the debit side(Dr.) being on the left and credit side (Cr) on the right.

Trial balance

After posting all journal entries in to the ledger a statement called Trial balance is prepared.

1) It checks the arithmetical accuracy of the entries.
2) It is simply a list of accounts and their balances at any given date.

3) It is used to test the equality of the balances because at any time the debits and credits should be equal in value.
4) It prepares materials for formulating the profit and loss account and balance sheet.

Profit and loss statement

1. Income statement or profit and loss statement is a statement of revenues and expenses for a specified period of time.
2. It reports the results of operations of a given period, normally one year.
3. A simplified profit and loss statement is given below.

Profit and loss of the Company XYZ Ltd. For the year ended on 31st March 2007

Revenues		
Sales		50,000
Other income		Nil
Expenses		
Cost of goods sold	25,000	
Selling expenses	8000	
Administrative Expenses	10,000	
Income tax	2,000	
Net profit	5,000	
	50,000	50,000

Balance sheet

1. A balance sheet is a statement showing the financial status of the company on the close of the last day of the company's financial year.
2. It is a statement of the assets, liabilities and capital
3. The balance sheet is divided in to two sides – on the right hand side is shown the assets and on the left hand side the liabilities of the company.
4. The basic relation in balance sheet is

   Total assets = Total liabilities
5. A simplified balance sheet is given below.

The balance sheet of the Company XYZ Ltd. as on 31st March 2007.

Liabilities		Assets	
Share capital		Fixed assets	
Reserves and surplus		Investments	
Secured loans		Current assets	
Unsecured loans		Stock in trade	
Current liabilities		Sundry debtors	
Provisions		Cash at bank	
Profit and loss account		Cash in hand	
		Loans and advances	
		Miscellaneous expenditure	
Total		Total	

All limited companies under Indian Companies Act of 1956 and the Amendment Act of 1960 have to maintain proper books of accounts, submit income tax returns and present balance sheet and profit and loss account at the annual general body meeting of the share holders with in a period of six months after the end of the financial year

Sources of Industrial Finance

1. Shares:_ Funds are collected by issuing shares to the public. The number of authorized shares that can be issued and the value of each share is specified. It may be classified as
   a) Preference shares: Preference shares have some preferential rights over other types of shares. They are entitled to a fixed dividend out of the profit. The dividend is first paid on preference share holders
      Preference shares may be classified as
      i. Cumulative preference shares.
      ii. Non – cumulative preference shares.
      iii. Participating preference shares: Fixed divided plus something from the surplus left after paying dividend to ordinary share holders.
   b) Equity share
      Dividend on equity shares is paid only after doing so on preference shares. They may get very high dividend in prosperous years and no dividend in the difficult years. Share holders are having full control over the affairs of the company.

2. Debentures:
   1. Debenture is a certificate of indebtedness issued by an enterprise.
   2. A debenture holder is a creditor only and has no control over the affaires of the company.
   3. Interest is paid whether the company runs in profit or loss.
   4. A debenture holder gets his money back after the stated number of years.
   5. In the event of the liquidation of the company. The debenture holder will get his money before the share holder gets it.
   6. Debentures are generally unsecured bonds which have no claim on any specific asset of the company.

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3. Bank loans: Short term and long term loans are easily availability from commercial and other banks on reasonable interest rates on mortgaging the assets of the company. Other facilities are i) Overdraft ii) Cash credit iii) Discounting of the bill etc.
4. Public deposits: Public may be asked to deposit their money directly with the company for a fixed period ranging from one year to seven years.

Financial Institutions

1. Industrial Finance Corporation of India (IFC): It was established in 1948 by a special enactment of parliament with an object of making medium and long term credits available to industrial concerns. IFC sanctions loans for many purposes like purchase of new machinery, construction of factory buildings. Loans are granted in Indian and foreign currency. It subscribes to equity shares, preference shares and debentures.
2. Industrial Development Bank of India (IDBI): IDBI was set up in 1964 as a wholly owned subsidiary of the Reserve Bank of India for providing credit and other facilities for the development of industry. The loan is usually available for acquiring fixed assets and not for working capital requirement.
3. Industrial Credit and Investment Corporation of India Ltd. (ICICI):
   ICICI was incorporated in 1955 primarily for promoting industrial development in the private sector. The funds are available for the purchase of capital assets in the form of land, building and machinery.
4. State Financial Corporation (SFC): Eg. Kerala Financial Corporation(KFC). Under the SFC act of 1951 various financial corporations have been set up for rendering financial assistance to industries in the medium and small scale sectors. The main activity of the SFC is to provide loans and advances and few of them under write shares of industrial concerns.
5. National Small Industries Corporation Ltd. (NSIC): NSIC was established in 1955 to assist, finance and promote the interest of small industries in the country. In- direct financial assistance is provided in the form of machinery and equipment on easy instalments under hire purchase scheme.
6. Unit Trust of India (UTI) : UTI is a financial institution in the public sector established in 1964. The main objective of the trust is to provide the facility of equity investment to savers of small and medium income groups. It channels these savings in to productive investments by subscribing to and under writing the shares and debentures of industrial undertakings.
7. Export Credit and Guarantee Corporation of India Ltd. (ECGC):
   ECGC was established in 1964 to encourage, facilitate and develop India’s export trade by
   a) Issuing insurance policies to exporters to protect them against losses in the event of certain commercial and political risks, due to blocking or delaying receipts of payments for goods exported.
   b) Furnishing guarantees to banks in India to enable the exporters to obtain on liberal basis pre shipment and post shipment credit facilities needed by them to maintain and expand the export trade.
8. Industrial Reconstruction Corporation of India (IRCI) :
   IRCI was set up in 1972 on the initiative of Reserve Bank of India with a view of rehabilitating industrial units turned ‘sick’ and stopped functioning.

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IRCI gives loans normally not available from normal financial and banking channels. It also give technical and managerial assistance.

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