Financial Management:

Functions of finance, Types of Capital-Fixed and Working Capital, Break Even Analysis.

Financial Management

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise.

It means applying general management principles to financial resources of the enterprise.

Scope:

Investment decisions:

Includes investment in fixed assets (called as capital budgeting).
Investment in current assets are also a part of investment decisions

Financial decisions :

They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.

Dividend decision :

The finance manager has to take decision with regards to the net profit distribution.

Net profits are generally divided into two:

- **Dividend for shareholders-** Dividend and the rate of it has to be decided.
- **Retained profits-** Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

- To ensure regular and adequate supply of funds to the concern.
- To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
- To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
- To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.
- To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.

Functions of Financial Management

1. Estimation of capital requirements:

• A finance manager has to make estimation with regards to capital requirements of the company.

•This will depend upon expected costs and profits and future programs and policies of a concern.

•Estimations have to be made in an adequate manner which increases earning capacity of enterprise.

2. Determination of capital composition:

•Once the estimation have been made, the capital structure have to be decided.

•This involves short- term and long- term debt equity analysis.

•This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.

3. Choice of sources of funds:

For additional funds to be procured, a company has many choices like-

- Issue of shares and debentures
- Loans to be taken from banks and financial institutions
- Public deposits to be drawn like in form of bonds.

Choice of factor will depend on relative merits and demerits of each source and period of financing.

4. Investment of funds:

The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.

5. Disposal of surplus:

The net profits decision have to be made by the finance manager. This can be done in two ways:

- Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
- Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.

6. Management of cash:

•Finance manager has to make decisions with regards to cash management.

•Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintenance of enough stock, purchase of raw materials, etc.

7. Financial controls:

•The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances.

•This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

The three important financial statements in the financial management are

1. Profit and loss statement
2. Balance sheet
3. Cash flow statement

1. The profit and loss statement/account

•The profit and loss statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period.

•The **P&L statement** is one of three financial statements every public company issues quarterly and annually, along with the **balance sheet and the cash flow statement**.

•When used together, the P&L statement, balance sheet, and cash flow statement provide an in-depth look at a company's financial performance together.

• Statements are prepared using the cash or accrual method of accounting.

•It is important to compare P&L statements from different accounting periods, as any changes over time become more meaningful than the numbers themselves.

• The P&L or income statement, like the cash flow statement, shows changes in accounts over a set period of time.

•The balance sheet, on the other hand, is a snapshot, showing what the company owns and owes at a single moment.

• It is important to compare the income statement with the cash flow statement since, under the accrual method of accounting, a company can log revenues and expenses before cash changes hands.

Company ABC Ltd.

Profit and Loss Statement

For the year ended December 31, 2018

Particulars	Amount ($)	Amount ($)
Sales	$1,000,000	
Cost of goods Sold	$ 600,000	
Gross Profit		**$ 400,000**
Operating Expenses		
Advertisement expenses	$ 60,000	
Depreciation expense	$ 80,000	
Rent expense	$ 15,000	
Payroll taxes	$ 5,000	
salaries and wages	$ 51,000	
Commission expense	$ 5,000	
Other Operating Expenses	$ 7,000	
Total operating Expenses		**$ 223,000**
Operating Income		**$ 177,000**
Non-operating Income		
Revenue from Interest	$ 10,500	
Interest Expenses	$ (9,100)	
Total Non- operating Income		**$ 1,400**
Net Income		**$ 178,400**

2. Balance sheet

• A balance sheet is a financial statement that reports a company's assets, liabilities, and shareholder equity.

• The balance sheet is one of the three core financial statements (other than **F&L, Cash flow statements**) that are used to evaluate a business.

• It provides a snapshot of a company's finances (what it owns and owes) as of the date of publication.

• The balance sheet adheres to an equation that equates assets with the sum of liabilities and shareholder equity.

• Fundamental analysts use balance sheets to calculate financial ratios.

What Does a Company Balance Sheet Tell You?

A balance sheet shows what a company owns and owes and how much shareholders have invested.

THE BALANCE SHEET FORMULA

Assets = **Liabilities** + **Shareholders' Equity**

cash, inventory, property

rent, wages, utilities, taxes, loans

retained earnings

Company Name Here

Balance Sheet

For the Period Ended _____

Assets				Liabilities			
Current Assets				**Current Liabilities**			
Cash		XXXXXX		Accounts Payable		XXXXXX	
Short-Term Investments		XXXXX		Salaries Payable		XXXXX	
Accounts Receivables		XXXXX		Accrued Interest		XXXXX	
Inventories		XXXXXXX		Taxes Payable		XXXX	
Prepaid Insurance		XXXXXX		Current Portion of Notes		XXXXXX	XXXXXXXX
Others		XXXXX	XXXXXX				
Long-Term Investments				Long-Term Liabilities			
Stock Investments		XXXXXX		Note Payable		XXXXXX	
Cash Value of Investments		XXXXXXX	XXXXXX	Mortgage Liability		XXXXXX	XXXXXXXX
Fixed Assets				**Total Liabilities**			XXXXXXXX
Land		XXXXXX					
Building and Equipment	XXXXXXX			**Stock Holder's Equity**			
Less Accumulated Depreciation	(XXXXX)	XXXXXX	XXXXXXX	Capital Stock		XXXXXXXX	
				Retained Earnings		XXXXXXX	
Intangible Assets							
Good will			XXXXXXX	**Total Stock Holder's Equity**			XXXXXX
Other Assets							
Receivables from Employees			XXXXXXXX				
Total Assets			XXXXXXXXX	**Total Liabilities**			XXXXXXXXX

Balance Sheet at at 31st March 20XX

Particulars	Schedules	Amount
Equity and Liabilities		
Shareholder's Funds:		
• Share capital		XXX
• Reserves and Surplus		XXX
Non-current Liabilities:		
• Long term borrowings		XXX
• Deferred tax liabilities		XXX
• Long term provisions		XXX
Current Liabilities:		
• Short term Borrowings		XXX
• Trade Payables		XXX
• Other current liabilities		XXX
• Short term provisions		XXX
Total		**XXX**
Assets		
Non-current Assets:		
• Fixed Assets		
○ Tangible Assets		XXX
○ Intangible Assets		XXX
• Non-Current Investments		XXX
• Long term loans and advances		XXX
Current Assets:		
• Current Investments		XXX
• Inventories		XXX
• Trade Receivables		XXX
• Cash and Cash Equivalents		XXX
• Short-term loans and advance		XXX
Total		**XXX**

3. Cash flow statement

• The cash flow statement (CFS), is a financial statement that summarizes the movement of cash and cash equivalents (CCE) that come in and go out of a company.

• The CFS measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses.

• As one of the three main financial statements, the CFS complements the balance sheet and the income statement.

A cash flow statement summarizes the amount of cash and cash equivalents entering and leaving a company.

The CFS highlights a company's cash management, including how well it generates cash.

This financial statement complements the balance sheet and the income statement.

The main components of the CFS are cash from three areas:

Operating activities,
Investing activities,
Financing activities.

The two methods of calculating cash flow are the direct method and the indirect method.

These **operating activities** might include:

- Receipts from sales of goods and services
- Interest payments
- Income tax payments
- Payments made to suppliers of goods and services used in production
- Salary and wage payments to employees
- Rent payments
- Any other type of operating expenses

Investing activities include any sources and uses of cash from a company's investments.

Purchases or sales of assets,

Loans made to vendors or received from customers,

Any payments related to mergers and acquisitions (M&A)

Cash from investing are usually considered cash-out items because cash is used to buy new equipment, buildings, or short-term assets such as marketable securities.

Cash from financing activities includes

The sources of cash from investors and banks, as well as the way cash is paid to shareholders.

This includes any dividends, payments for stock repurchases, and repayment of debt principal (loans) that are made by the company.

Changes in cash from financing are cash-in when capital is raised and cash-out when dividends are paid.

Thus, if a company issues a bond to the public, the company receives cash financing. However, when interest is paid to bondholders, the company is reducing its cash.

There are two methods of calculating cash flow:

1,. The direct method

2. The indirect method.

Direct Cash Flow Method

The direct method adds up all of the cash payments and receipts, including cash paid to suppliers, cash receipts from customers, and cash paid out in salaries.

This method of CFS is easier for very small businesses that use the cash basis accounting method.

Indirect Cash Flow Method

With the indirect method, cash flow is calculated by adjusting net income by adding or subtracting differences resulting from non-cash transactions.

Non-cash items show up in the changes to a company's assets and liabilities on the balance sheet from one period to the next.

Therefore, the accountant will identify any increases and decreases to asset and liability accounts that need to be added back to or removed from the net income figure, in order to identify an accurate cash inflow or outflow.

Changes in accounts receivable (AR) on the balance sheet from one accounting period to the next must be reflected in cash flow: If AR decreases, more cash may have entered the company from customers paying off their credit accounts—the amount by which AR has decreased is then added to net earnings.

An increase in AR must be deducted from net earnings because, although the amounts represented in AR are in revenue, they are not cash.

Cash Flow Statement

Big Tex's Mechanical Bull Rentals and Servicing

Month Ended September 30th, 2019

Cash Flow from Operations	
Net income	$12,000
Additions to Cash	
Depreciation	$3,000
Increase in Accounts Payable	$1,000
Subtractions from Cash	
Increase in Accounts Receivable	($8,000)
Increase in Inventory	($7,000)
Net cash from Operations	$1,000
Cash Flow from Investing	
Purchase of equipment	($2,000)
Cash Flow from Financing	
Notes payable	$2,000
Cash Flow at September 30th, 2019	$1,000

Capital

• In order to start and run a business i.e to produce and sell goods or services, money has to be invested. The money invested in the business in order to yield an income is known as Capital.

• Capital is needed for the following purposes

1. Purchasing fixed assets(building, Equipment, tools, furniture)
2. Purchase of raw materials and other supplies
3. To meet the day to day expenditure such as wages of workers, Selling and distribution expenses, equipment and plant maintenance costs etc.

Importance and scope of Capital

- Capital plays a vital role in the modern productive system. Capital is the life blood of any business.
- Capital is one of the important factor of production. It plays a strategic role in raising productivity.
- Another important economic role of capital formation is the creation of employment opportunities in the country.
- If the population grows faster than the increase in the stock of capital then it will result in unemployment. The rate of capital formation must be kept sufficiently high so that the employment opportunities are enlarged.
- In India the stock of capital has not been growing at a fast enough rate so as to keep pace with the growth of population. That is why there is huge unemployment and under-employment in both the urban and rural areas.

Types of capitals: Fixed capital and working capital

The two types of capital necessary in their company venture are

1. **Fixed capital**
2. **Working capital**.

An entrepreneur can preserve a perfect balance between their assets and liabilities and strive toward earning more substantial revenue by using these two capitals.

Fixed Capital

- Fixed capital refers to the cash used to acquire long-term assets or fixed assets.
- These fixed assets are the first and most important purchases a firm makes, and they are used to manufacture the final product on a continuing basis.
- These inexhaustible assets aren't used or depleted in a single accounting period.

Fixed capital is required for the following items

1. Land
2. Building and other installation
3. Power and electric supply installation
4. Water supply and drainage fittings
5. Machinery, material handling equipment
6. Tools
7. Administrative office and equipment
8. Patents

Working Capital

Working capital is required to meet the expenditure for day to day working of the business. It includes

1. The cost of raw materials, purchased parts, supplies, material in process and finished goods
2. Wages and salary bills
3. Cost of maintenance and service activities, utilities and fuel, property taxes and insurance
4. Cost of sales activities such as advertising, shipping services and credit extension to customers.

Factors affecting working capital

- Length of period of manufacture
- Turnover of Inventories
- Terms of purchase and sales
- Size of the business
- Seasonal variations
- Importance of Labour
- Business cycle
- Banking Facilities
- Nature of Business

Fixed capital - working capital

•The part of an organization's total capital that is invested in long-term assets is known as fixed capital. Working capital is the money needed to run a business on a daily basis.

•Fixed capital investments are durable products that will stay in the firm for longer than one accounting period. The company's working capital, on the other hand, is made up of short-term assets and liabilities.

•Fixed capital is generally illiquid since it cannot be quickly converted to cash. Working capital investments, on the other hand, may be converted into cash quickly.

•Fixed capital is used to acquire non-current assets for the firm, whereas working capital is used for short-term finance.

•The entity's strategic objectives, which include long-term business planning, are supported by fixed capital. Working capital, on the other hand, is used for a variety of purposes

Working capital management

Working capital management requires monitoring a company's assets and liabilities to maintain sufficient cash flow to meet its short-term operating costs and short-term debt obligations.

Objectives:

- To maintain sufficient cash flow to meet its short-term operating costs and short-term debt obligations and maximize profitability.

- To maintain an optimum cash conversion cycle (CCC), or the amount of time a firm uses to convert working capital into usable cash.

Working capital management involves tracking various ratios, including the working capital ratio, the collection ratio, and the inventory ratio.

Working Capital Ratio = Current Assets / Current Liabilities

Collection ratio = total receivables/average daily sales

Inventory ratio = cost of goods sold/average inventory

Working capital management can improve a company's cash flow management and earnings quality by using its resources efficiently.

A company's working capital is made up of its current assets minus its current liabilities.

Current assets include anything that can be easily converted into cash within 12 months. These are the company's highly liquid assets. Some current assets include cash, accounts receivable, inventory, and short-term investments.

Current liabilities are any obligations due within the following 12 months. These include accruals for operating expenses and current portions of long-term debt payments.

Working Capital Ratio (current ratio)

If a company has a Working Capital Ratio (current ratio) of less than 1.00, this means that short-term debts and bills exceed current assets, a signal that the company's finances may be in danger in the short run.

Collection Ratio

If it takes a long time to collect, it can be a signal that there will not be enough cash on hand to meet near-term obligations.

Working capital management tries to improve the collection speed of receivables.

Inventory Ratio

A relatively low ratio compared to industry peers indicates a risk that inventory levels are excessively high, while a relatively high ratio may indicate inadequate inventory levels.

BREAK-EVEN ANALYSIS

•Two broad heads of costs are associated with production, *i.e., costs of capital assets* and costs of production.

•The classification and analysis of costs are important to enable the manager to exercise proper control on costs so as to manufacture the products at the pre-established cost level.

• Bre**ak-even analysis** helps to understand the costs and to calculate the point at which we cover all the costs.

COSTS OF PRODUCTION

The costs of production include:

1. Purchase costs of raw materials, bought out components and subassemblies, procurement and transportation costs.
2. Purchase costs of supplies such as oils, lubricants, tools of small value, fuel oil, machlnery spares, cotton waste, etc.
3. Wages and salaries paid to direct production workers, maintenance inspection, stores staff, supervisors and other staff.
4. Costs paid to subcontractors for the orders placed on them.
5. Cost of production line rejections, wastage, spoilage and rework.
6. Expenses towards rent and insurance of factory buildings, insurance on plant and machlnery, stores, etc.
7. Interest on working capital to the extent it relates to inventory.
8. Cost of procurement of capital assets like buildings, machinery, tooling, inspection equipment, furniture, etc., and the depreciation of these capital assets.

CLASSIFICATION OF COSTS

Classification of costs are based on the following:

1. Natural characteristics (material, labour and overhead)
2. **Changes in activity or volume (fixed, variable, mixed)**
3. Degree of traceability to the product (direct cost, indirect cost)
4. Costs for analytical and decision-making (sunk costs, opportunity costs))
5. Other classifications (miscellaneous).

Fixed cost:

•The costs which do not change for a given period in spite of change in volume of production.

•This cost is independent of volume of production.

•Fixed costs are normally expressed in terms of time period *i.e., per day, per annum, etc*

•Fixed cost does not mean that they never change. They are constant up to specific volume or range of volume

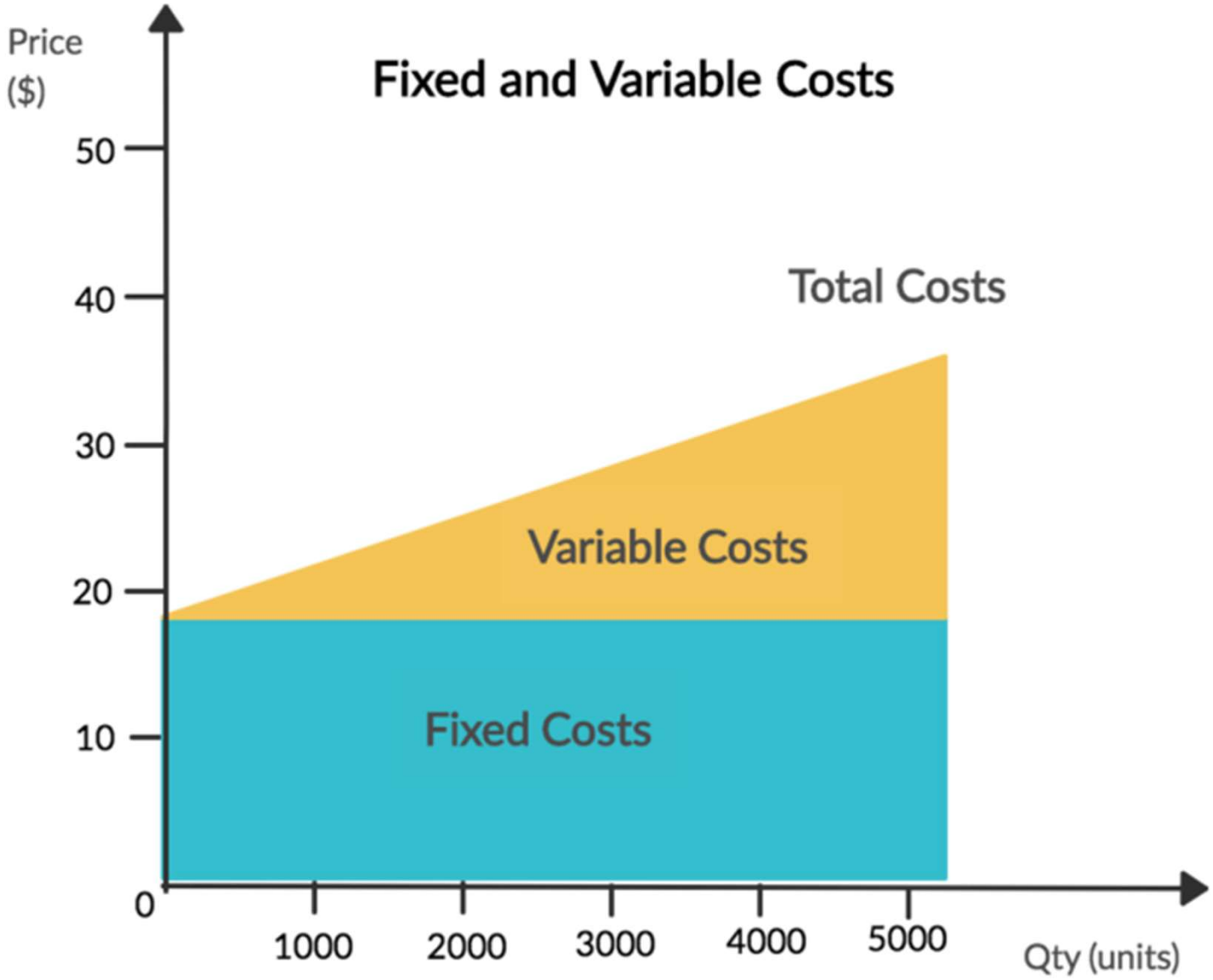
Variable costs:

•These vary directly and proportionately with output.

•There is a constant ratio between the change in the cost and change in the level of output.

•Direct material cost and direct labour costs are generally variable costs.

•Variable costs results from the utilisation of raw materials and direct labour in production


Price
($)
Fixed and Variable Costs
50
40
30
20
10
0
Total Costs
Variable Costs
Fixed Costs
1000
2000
3000
4000
5000
Qty (units)

BREAK-EVEN ANALYSIS

•Break-even analysis establishes the relationship among the factors affecting profit.

•It indicates at what level cost and revenue are in equilibrium.

• It is a simple method of presenting to management the effect of changes in volume on profit.

•The detailed analysis of break-even data will help the management to understand the effect of alternative decisions that convert costs from variable to fixed, the costs which increase sales volume and revenue.

•It is a powerful tool in evaluating alternative course of action.

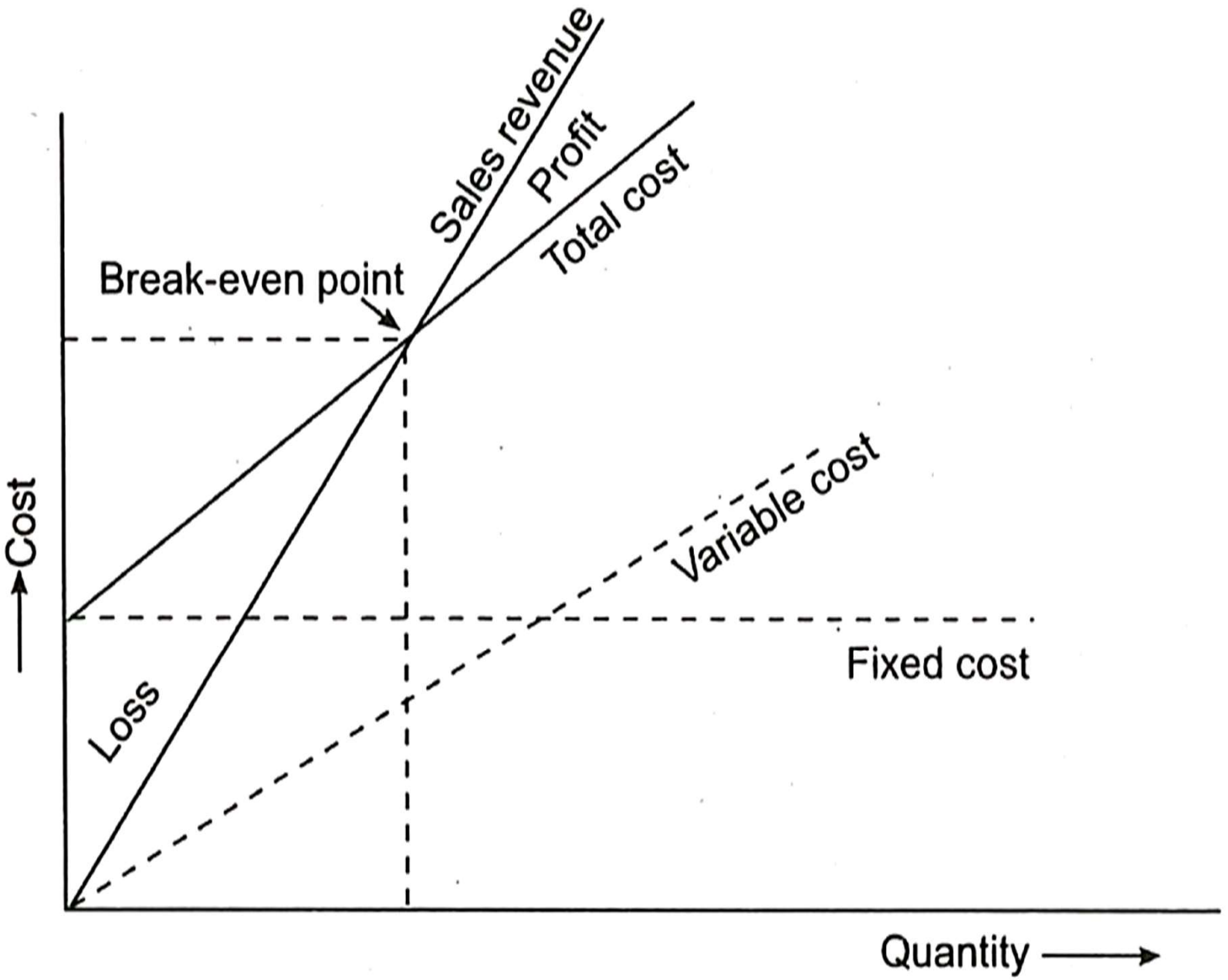
Assumptions in Break-Even Analysis

1. Selling prices will remain constant at all sales levels (Quantity discounts are not available)
2. There is a linear relationship between sales volume and costs.
3. The costs are divided into two categories-Fixed costs, those costs which does not vary with volume (quantity) and variable costs will be varying in direct proportion to quantity.
4. Production and sales quantities are equal. (There is no inventory)
5. No other factors will influence the cost except the quantity.

•**Break-even point** refers to the level of sales (sales volume) at which the sales income (revenues) equal the total costs.

• It is a point at which the profit is zero. The quantities produced (sold) above break-even point result in profits and quantity below break-even point result in losses.

•The break-even point is reached when the fixed costs are completely recovered.



Break-even chart.

Let

F	*represents the fixed cost.*
Q	is quantity produced and sold.
b	is the sales price per unit.
a	*is variable cost per unit.*
bQ	*total income (revenue).*
aQ	*total variable cost.*

Total costs = Fixed cost + variable cost = $F + aQ$

At *BEP, Total costs equal total income*

Therefore, Total cost = Total income.

$$F + aQ = bQ$$

$$Q = F/b—a$$

Contribution = Sales - Variable cost = $b - a$

Break-even Quantity (units) = Fixed cost / Contribution

Example 1

Fixed Factory Overheads Cost	60,000
Fixed Selling Overheads Cost	12,000
Variable Manufacturing Cost per unit	12
Variable Selling Cost per unit	3
Selling Price per unit	24

(i) ***Break–even point*** $= \dfrac{\text{Fixed Cost}}{\text{Selling Price per unit} - \text{Variable Cost per unit}}$

Variable Cost per unit $= ₹\ 12 + 3 = ₹\ 15$

Total Fixed Cost $= ₹\ 60,000 + 12,000 = ₹\ 72,000$

B.E.P. $= \dfrac{72,000}{24 - 15} = 8,000$ units

B.E.P. (in sales values) $= 8,000 \times 24 = ₹\ 1,92,000$

(ii) ***Number of units that must be sold to earn profit of ₹90,000***

$$= \frac{\text{Fixed Cost} + \text{Profit}}{\text{Selling Price per unit} - \text{Variable Cost per unit}}$$

$$= \frac{72,000 + 90,000}{24 - 15} = \frac{1,62,000}{9} = 18,000 \text{ units.}$$

Example 2

	₹
Variable Cost per unit	15
Fixed Expenses	54,000
Selling Price per unit	20

Contribution per unit = Selling Price – Variable cost per unit
= ₹ 20 – 15 = ₹ 5

(a) ***B.E.P.*** $= \dfrac{\text{Fixed Expenses}}{\text{Contribution per unit}}$

$= \dfrac{54,000}{5} = 10,800$ units

(b) What should be the selling price per unit, if the break-even-point should be brought down to 6000 units:

$$\text{B.E.P.} = \frac{\text{Fixed Expenses}}{\text{Contribution per unit}}$$

Or, $6,000 = \dfrac{54,000}{\text{Contribution per unit}}$

Or, Contribution per unit $= \dfrac{54,000}{6,000} = \text{Rs. } 9$

Contribution = S.P. – V.C.

Or, $9 = SP - 15$

Or, Selling Price = ₹ 24.