CHAPTER NO. III

Financial Management In Swami Ramanand Bharati Co-Operative Spinning Mills Ltd, Tasgaon

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CHAPTER NO. III

Financial Management In Swami Ramanand Bharati Co-Operative Spinning Mills Ltd, Tasgaon

3.1 Introduction

The existence of any business concern is depending upon the adequacy of capital or funds or money at required time. Incoming or outgoing of funds must be balanced and timely. Finance or funds or money are required not only for new business firms but it is equally essential for established firms for its existence, continuity and for expansion. In short finance means provision of money for any economic activity of the business firm. Any economic activity can't be carried out without sufficient finance. Therefore finance is called lifeblood of the business concern, heart of business or universal lubricant of the business engine. The capital must be in sufficient manner. Sufficient capital is that capital which is not more not less. The overcapitalization and under capitalization both are harmful for the business firms. Therefore the finance manager's role is to decide optimum requirement of finance. The funds or money are needed mainly for two purposes fixed asset purpose and working capital purpose.

3.2 Meaning and definition

Financial Management is concerned with financial decision-making. Financial Management is optimum utilization of funds and raising the funds at an optimum cost at an appropriate time. Thus financial management is concerned with management of funds or money. The finance manager is more concerned with maintenance of firm's solvency and liquidity by providing the cash flows necessary to meet

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requirements of the firm from time to time. In short financial Management is nothing other than Asset Mixture, Capital Mixture and Profit Sharing Policy of the business concern.

3.3 Functions of financial Management

From the above meaning and definitions of Financial Management three functions involved in it. These functions are also called as decisions of Financial Management. Each and every manager must take these decisions in daily routine life of the business firm. These are explained below.

3.3.1 Financing Decision

Financing decision involves how to raise the required finance. There are various ways of getting the funds or money, such as equity share capital, preference share capital, debentures, loans from financial institutions and ploughing back of profits and government assistance or government share capital etc. Financing decision is mainly concerned with determination of the proportion of equity and debt in capital structure of an enterprise. The mix of debt and equity is called as capital structure or financing mix or leverage. Debt capital has fixed interest source of finance while equity capital has variable return source of financing. The Swami Ramanand Bharati Co-operative spinning Mills Ltd, Tasgaon formulate the capital structure is as follows;

1) Members Equity Capital
2) Government Equity Capital
3) Loans from banks and Financial Institutions

That particular capital structure will be decided after considering the cost of capital of these sources of finance.

3.3.2 Investment Decision

The second important function or decision of Financial Management is that investment decision. It involves invest the funds in fixed capital and working capital. Fixed assets are those assets, which are useful for the business for a long period and these having huge costs. And this asset gives the benefits in future long probable period. These assets are land, building, plant and machinery and furniture etc. And secondly the capital is required for working capital purpose. Working capital is the difference between current assets and current liabilities. Working capital is required for day-to-day routine operations of the business concern. Without sufficient working capital any business concern can't in smooth manner. Therefore the working capital is called lifeblood of the business concern. The Swami Ramanand Bharati Co-operative Spinning Mills Ltd, Tasgaon invested the funds in fixed assets are amounted to Rs.33, 56,14,653 and in working capital amounted to Rs.1,89,88,464 in the year 2007-08.

3.3.3 Dividend Decision

The major and significant financial decision is the decision relating to the dividend decision. The profits earned by the firm may either distribute to the shareholders in the form of dividend or retained in the business in the form of reserves. The finance manager may take the decision of about the dividend declaration or to create the reserves. The reserves are used for capitalization purpose. The decision will depend upon the preference of shareholders and investment opportunities available within the firm. The financial manager should also consider the other factors such as dividend stability, class of the shareholders, cash availability etc. The SRBCSMLT has did not declared dividend in previous two successive years i.e. 2006-07 and 2007-08. They have been

created reserves for capitalization purpose. The amount of accumulated profits was Rs.87, 30,678 in the year 2007-08.

3.4 Objectives of Financial Management

The decisions or functions of financial management are performed in the light of objects or goals or approaches of financial management. There is an interesting controversy regarding the goals of financial decision-making. i.e. should the goal of financial management may be profit maximization or wealth maximization. These two widely discussed objectives are discussed below.

3.4.1 Profit Maximization

One approach to financial decision-making criterion is profit maximization. As per profit maximization all those activities are undertaken which yields profits, and these activities are avoided which yields loss. Profit is measure of efficiency, profit ensures welfare of the shareholders these are some agreement in favor of profit maximization. But here profit is a vague concept or ambiguous concept. It conveys different meaning to different peoples. This concept did not consider time value of money and quality of benefits.

3.4.2 Wealth Maximization

Another investment criterion or goal of financial management is wealth maximization. As per wealth maximization concept of financial decision making the wealth of the shareholders or owners is increased or maximized. Maximization of wealth means maximization the net present value of an investment proposal to the owners or shareholders. Net present value is the difference between present value of its benefits and the present value of its costs. A financial action creates maximum wealth through positive NPV is more desirable. This objective of wealth

maximization is an exact. It considers time value of money and also considers risk factors.

3.5 Techniques of Financial Management

In the light of three functions and two widely approaches of financial management the following techniques are used in financial management.

3.5.1 Financial statement Analysis

For the successful operation of an undertaking, the fundamental understanding of financial statements is essential. Financial statements are very useful to the business to measure the financial position and profit earning capacity of the business.

Financial statements are prepared for the purpose of presenting a periodical review by the management and deal with the status of investment in the business and results achieved during the period of review.

3.5.1.1 Objectives of Financial Statements

The objectives of financial statements are as under

1) To serve as the basis for future operation
2) To provide sufficient financial information to the various parties.
3) To provide financial data on economic resources and obligation.
4) To profit earned and loss suffered during a specific period.
5) To present true and fair view of the business.

3.5.1.2 Types of financial statements

Financial statement are presented in the various types as under

1) Profit and loss Account, and
2) Balance Sheet.

3) Profit and loss Appropriations Account

4) Statements Of changes Of Financial Position

3.5.1.3 Meaning of Analysis

The analysis of financial statements provides valuable information for managerial decisions. Financial statements don't speak anything. It contains financial data about business events. The user may gain these data through his own analysis.

Financial statement analysis involves a systematic examination of information contained in the financial statements.

"Financial statement analysis is a study of relationship among the various financial factors in a business, as disclosed by a single set of statements and study of these factors as shown in a series of statements."

John N. Myer.

Thus financial statement analysis is a process of analyzing the financial data in order to judge the profitability and financial position of a concern.

3.5.1.4 Steps in Financial Statement Analysis

1) Object and scope of analysis.
2) Study of financial statements.
3) Collection of relevant information.
4) Arrangement of data.
5) Analysis of data.
6) Interpretation and presentation and preparation of reports.

3.5.1.5 Importance of Financial Statement Analysis

Financial statement analysis has an importance to the various persons as under

1) Owners
2) Management

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3) Government

4) Investors

5) Creditors

6) Employees etc.

3.6 Techniques Of Analysis

Various techniques have been developed for the analysis of financial statements and they are as under.

3.6.1 Comparative Financial Statements

"Comparative financial statements are statements of the financial position of a concern, as to provide time prospective to the consideration of various elements of financial position embodied in such statements."

It discloses the changes in the items on financial statements both in rupee and percentage. The analyst calculates the absolute changes and also percentage changes from one year to another year to the next year, using the earlier year is base year.

3.6.2 Common Size Statements

Common size comparative statements prepared for one firm over the years would highlight the relative changes in each group of expenses, assets and liabilities. These statements can be equally useful for inter-firm comparisons, given the fact that absolute figures of two firms of the same industry are comparable.

3.6.3Trend Analysis

For the purpose of comparative study of financial statements over a number of years trend percentage or ratios are very useful.

Out of the periods under study any one year is taken as base year and each item in this year is taken as 100. Percentage

of the same item in each of remaining years is calculated. As the large amounts are reduced to percentages, the management finds it easy to compare and know the trends.

3.6.4 Ratio Analysis

Ratio analysis is a technique used in financial management in analyzing and interpreting the financial statements. A ratio is a statistical unit or yardstick expressed in pure numbers e.g. (2: 1) or in percentage e.g. (5%) and used to measure relationship between two figures, quantities or two factors in a statement. It is a simple mathematical expression. For better understanding the results, efficiency, soundness etc, a comparison of things expressed through ratios is a must.

3.6.4.1. Importance of Ratios

Following are some of the advantages of ratio analysis to the business enterprise.

1) Ratio can be used as one of the tools of analyzing, interpreting and studying the financial statements.
2) It helps in simplifying the complex data.
3) It can be used in studying the financial soundness and operating efficiency of an organization.
4) It is useful in forecasting and budgeting purpose.
5) Ratio analysis can be used for inter-firm and inter-period comparison.

3.6.4.2. Types of Ratios

In facts the accounting ratios have been classified in a number of ways depending on the view points of the persons using the ratios or on the basis of importance and on the nature of the ratio. The most commonly and widely accepted ratios are as follows:

1) Profitability Ratios

Profit is the difference between revenues and expenses over a period of time. Profit is the ultimate output of the company. The profitability ratios calculated to measure the operating efficiency of the company; creditors and owners are interested in the profitability of the concern. It includes Gross Profit ratio, Net Profit Ratio, Operating Ratio and Operating profit Ratio etc.

2) Solvency Ratios

Solvency ratios or liquidity ratios measures the ability of the firm to meet its current obligations. This ratio maintains a relationship between cash and other current assets to current obligations. Any Organization failing to meet its obligation will result into bad credit image, loss of creditor's confidence. It includes two important ratios such as Current Ratio and liquidity Ratio.

3) Turnover Ratios

The funds of creditors and owners are invested in various assets to generate more income. The better management of assets, the larger amount sales. Activity ratios involve a relationship between sales and assets. It includes Stock Turnover Ratio, Creditors Turnover Ratio and Debtors Turnover Ratio.

4) Leverage Ratios

The short-term creditors are more concerned with the current debt paying ability of any organization. But the long-term creditors are more concerned with the firm's long-term financial strength. To judge the long term financial position of any firm, financial leverage is calculated. It includes Debt Equity Ratio and long Term Liabilities to Net worth ratio etc.

3.6.4.3. Limitations of Ratios

Ratio analysis will help little help to the users and its expression will misleading and misguiding if the analysis of figures, quantities etc, are based on wrong footings such as

1) Incorrect accounting information.
2) Different policies adopted by different firms.
3) Use of different standards in different firms
4) Analysis of insignificant and unrelated quantities.
5) Absence of actual quantities.
6) Different meanings attached to various items by different firms.

3.7 Capital Budgeting

The term capital budgeting refers to long term planning of capital expenditure decisions. The capital budgeting decisions therefore involves a current outlay or series of outlays of cash resources in return for an anticipated flow of future benefits. It is essential because of the following:

1) Huge investment- The most important significance of capital budgeting is these decisions require very large amount of funds. The need of substantial funds needs proper care before investment made in fixed assets.
2) Long term investment- These decisions have long term implications. The effect of these decisions will extend into the future. A wrong decision can prove disastrous for the long-term survival of the firm.
3) Irreversible decision- The decisions ones taken and acted upon can not be corrected. And when you want to change it, it is resulted into heavy losses.

4) Complicated decisions- These decisions are complicated in nature. Theses decisions require an assessment of future events, which are uncertain.
5) National importance- Capital budgeting decisions has an national importance. If the investment made in proper projects and beneficial one it will result into proper utilization of the resources of the nation. And it creates industrial growth and employment opportunities.

3.7.1 Methods of Capital Budgeting

This section includes methods of appraising an investment proposal are those, which are objective, quantified, and based on economic costs and benefits. The methods of capital expenditure are classified into two broad categories:

1) Traditional Methods

a) Pay back Period Method b) Average Rate of Return Method

2) Time Adjusted Methods

a) Net Present Value b) Internal Rate of Return c) Profitability Index

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3.8 Working Capital Management

Working capital is the difference between current assets and current liabilities. Working capital is required for day-to-day affairs of the business the business concern. Working capital is the lifeblood of the business concern; working capital is universal lubricant of the business engine and the heart of the business concern. The following are the some determinants of working capital.

1) Nature of Business- Nature of business concern affect on the requirement of working capital. A trading company requires comparatively large amount of working capital than manufacturing concern. Manufacturing business concern requires both fixed and working capital.
2) Size of Business- The amount of working capital depends upon volume of business. Larger the size large amount of working capital is required and smaller the size small amount of working capital is sufficient.
3) Terms and Conditions of Purchases and Sales- The requirement of working capital depend upon the terms (cash or credit) of purchases and sales. Cash purchases require more amount of working capital. A credit purchase reduces the need of working capital. Similarly a cash sale reduces need of working capital and credit sales increases need of working capital.
4) Banking Facilities- Developed banking system reduces the need of working capital and vice-versa.
5) Communication Facilities- If the communication system is well advanced in the country it reduces the need of working capital and vice versa.

6) Availability of Raw Materials- The availability of raw material in local region and in any time it may be available in the market, it reduces the need of working capital and vice-versa.
7) Seasonal variations- During the busy season a business requires larger working capital, while during slack season a company requires lower working capital.
8) Growth and Expansion Need of Business- If expansion of business is made at normal rate retained profits can be made use of for the purpose. However for the rapid growth, such profits are not available and this increases the need of working capital.

3.8.1 Concepts of Working Capital

There are two concepts of working capital: gross and net
The term gross working capital also referred to as working capital means the total current assets.

The term net working capital can be defined in two ways 1) the most common definition of net working capital (NWC) is the difference between current assets and current liabilities; 2) and alternate definition of (NWC) is that portion of firm's current assets which is financed with long term funds.

3.9 Capital structure

The optimum capital structure may be defined as that capital structure or combination of debt and equity that leads to the maximum value of the firm.

The importance of capital structure is, thus, obvious. There is a viewpoint that strongly supports the close relationship between leverage and value of the firm. There is an equally strong body of opinion, which believes that financing mix or combination of debt and equity has no impact on shareholder's wealth and the decision on financial structure is irrelevant. In other words there is nothing such as optimum capital structure.

There are various capital structure theories are given below:

1) Net Income Approach
2) Net Operating Income Approach
3) Modigliani-Miller Approach and
4) Traditional approach etc.

3.10 Cost of Capital

The cost capital can be defined, as the rate of return the firm requires from investment in order to increase the value of the firm in the market place.

A firm's cost of capital represents the minimum rate of return that will be result in an least maintaining the value of its equity shares. Such rate may be calculated on the basis of actual cost different components of capital. It comprises three components.

1) Return at Zero Risk Level
2) Premium for business Risk
3) Premium for Financial Risk

3.10.1 Significance of Cost of Capital

1) As a basis for evaluating financial performance
2) As an acceptance criterion in capital budgeting
3) As a determinant of mix in capital structure decisions
4) As a basis for taking other financial decision

As per the above study it is clear that the financial management is nothing other than asset mixture, Capital mixture and profit sharing policy of the business concern.