CHAPTER -II

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2.1 INTRODUCTION :

Finance is one of the basic need of all kinds of business enterprises. It is the lifeblood of business. No business can be established or run without finance. The enterprise success and survival depends upon how efficiently it is able to raise funds as and when needed and their proper utilisation. In this way finance is a master key that provides access to the sources to be employed in economic activities.

1. MEANING OF FINANCE :

Generally, in business, the term 'finance' is interpreted with three meanings.

The first meaning signifies that the 'finance' keeps the business supplied with enough funds to accomplish its objectives.

The Second meaning is concerned with cash, since every business transaction is ultimately translated into the cash it generates, invests or uses it.

Third meaning has found wider acceptance, according to which, 'finance' performs the function of funds and their effective utilisation in the conduct of a business. In this third meaning 'finance', the funds could be private finance, public finance, personal finance, or business finance. Basically finance does not mean merely the supply of money but finance is the money utilised for doing some business to earn more money.

2. DEFINITION OF FINANCE :

Finance is the process of conversion of accumulated funds into productive use.

i) "Finance may be defined as the administrative area or set of administrative functions in an organisation which related with the arrangement of cash and credit so that the organisation may have the means to carry out is objective as satisfactorily as possible".(1)

---- Howard and Upton

ii) "Business Finance is that business activity which is concerned with acquisition and conversion of capital funds in meeting the financial needs and overall objectives of the business enterprise".(2)

----- Wheeler

iii) "Business Finance can broadly be defined as the activity concerned with planning, raising, controlling and administering the funds used in the business".(3)

---- Guthaman and Dougall

iv) "The Finance function is the process of acquiring and utilising funds by a business".(4)

---- R. C. Osborn

v) "Financing consists in the raising, providing, managing of the money capital or funds of any kinds to be used in connection with the business".(5)

--- Bonnerville and Dewey

vi) "Business Finance deals primarily with raising, administering and disbursing funds by privately owned business units operating in non financial field of industry".(6)

--- Prather and Wort

In brief finance means collecting the funds and putting them to proper and effective utilisation in the conduct of business.

Success of failure of an organisation depends largely on how efficiently decision relating to procurement and allocation of funds, cash flow, estimates, requirements controls of current performance, etc.are made Efficient financial management stimulates growth of the organisation and contributions to national progress therefore, it can be considered as a key determinant of any business organisation.

2.2 NEED OF FINANCING TO BUSINESS :

Finance means money utilised for doing some business to earn more money. The need of finance means need of money to the business for acquisition of other resources like men, machine, materials etc. We all known the adage an old saying well known proverb "money is want what money does", It is true for a business unit also, if dose want money for its own sake. It wants money to be able to exercise command over the various resources.

The need of financing to business arises mainly for two factors namely provision for acquisition of fixed assets and acquisition of working funds or working (or circulating capital) Fixed assets include land, building, plant, machinery, equipment, etc. which are used period longer than one year), to enable the business to earn profits.

Working capital is necessary to meet the day to day revenue expenditure like of purchases of materials, payment of wages, payment for overhead expenses etc. working capital keeps the business going since physical asset (like plant and machinery) cannot by themselves effect any production or sales unless they are regularly fed with materials and services. the finance needed to provide continuously for such materials and services is actually the working capital. the two areas namely, fixed capital and working capital representing financial need differ widely in respect of both the sources and servicing of finance and the modes of utilisation of the same.

2.3 ESTIMATION OF FINANCIAL NEEDS :

TOTAL FINANCE

SHORT TERM
(WORKING CAPITAL)

SOURCES

1) TRADE CREDIT
2) COMMERCIAL BANKS -
   i) Loans
   ii) Cash Credit
   iii) Hypothecation
   iv) Pledge
   v) Over drafts
   vi) Bills discounted & purchased
3) ACCRUAL ACCOUNTS

LONG TERM
(FIXED CAPITAL)

1) Depreciation as a source of finance
2) Financing through Retained earnings

1. WORKING CAPITAL :

Working capital is the amount of funds which a business must have to finance its day-to-day operations. Working capital is a part of the total capital that circulates from one asset to another in the ordinary course of business. This idea indicates recurring transactions from cash to inventories, inventories to receivable, receivables in to cash, and forms a continuous chain of business operations.

a) **Working Capital Cycle :**

STOCK

PRODUCTION SALES

PURCHASES AND EXPENSES DEBTORS AND BILLS RECEIVABLE

CASH COLLECTIONS

b) **Concepts of Working Capital :**

There are two concepts of the working capital, i) Gross Working Capital ii) Net Working Capital.

A Firm's investment in the current assets is called the 'Gross working capital'. These assets are usually converted in to the cash within an accounting year. Use of this concept is helpful in providing for the correct amount of working capital at the right time so that the firm is able to realise the greatest return on its investment.

The net working capital refers to the difference between the current assets and current liabilities. The use of concept of net working capital is useful for determining the ability to meet future operational needs and payment of current liabilities. Within an accounting year. Following are the chart of Net Working Capital -

CURRENT ASSETS		CURRENT LIABILITIES		
1) Cash in hand 2) Cash at bank 3) Bills receivables 4) Sundry debtors 5) Stock of goods	−	1) Creditors 2) Bills payable 3) Outstanding expenses 4) Short term loans 5) Mortgages	=	Net Working Capital

2. FIXED ASSETS :

Fixed Assets comprise land, building, plant and machinery, furniture and fittings and equipments etc. These are acquired not for the purpose of resale but for being used in the business in order to maintain and enhance its profit earning capabilities. Fixed assets have a long life and the period should be atleast one year. Assets having a life of less than a year are usually considered to be current assets. Because of the relatively long life span of fixed assets, it is financed by permanent or long terms sources. The use of short term sources of funds for acquisition of fixed assets leads to financial irregularity or indicipline.

Such subsequent acquisition of fixed assets may be attributed to the different types of needs that can be summarised by the expression B M R E D which is elaborated below,

BALANCING	:	Need of acquiring balancing equipment in order to correct capacity imbalances, if any.
MODERNISATION	:	Need for upgradation of technology and therefore acquiring some modern equipment to replace the obsolete one.
REPLACEMENT	:	Need for replacement of used up and worn put assets, by more or less identical ones.
EXPANSION	:	Need for enhancing the productive capacity by understanding some expansion projects.
DIVERSIFICATION	:	Need for diversification into allied or new lines by embarking on new projects for this purpose.

2.4 SOURCES OF RAISING THE FINANCE FOR THE BUSINESS :

Finance is the life blood of a business. The business unit cannot run efficiently, if it does not have adequate finance to meet its requirements. The financial requirements of business can be classified into two categories as follows.

1. Short term financial requirement.
2. Long term financial requirement.

1. SHORT TERM FINANCE REQUIREMENTS :

Short term funds are required for meeting working capital needs. They are usually required for a period up to one year. They are raised from sources which can provide funds only for a short period quickly and at a reasonable cost.

2. LONG TERM FINANCIAL REQUIREMENTS :

The long term funds are required to a great extent for meeting the fixed capital requirements of the business. They are required for a period exceeding one year. They are sometimes classified as -

a) Intermediate or medium term funds and

b) Long-term funds.

The medium term funds required for a period between 3 to 5 years, while long term funds are required for period exceeding 5 years.

The short-term and long-term requirements of finance for a business unit can be fulfilled by different sources of finance as follows :

A) SOURCE OF SHORT TERM FINANCE :

The short-term Loans/credits are obtained for working capital requirements. The following are the important sources of short term finance.

1) TRADE CREDIT :

The trade credit is a form of short term financing common to almost all types of business firms. As a matter of fact it is the largest source of short term finance. In an advanced economy most of the buyers are not required to pay for goods on delivery. They are allowed a short term credit period before payment is due.

Trade credit arrangement is generally made available to the buyer on an informal basis without creating any charge on the assets. Trade credit arrangement usually carry stipulation of allowing a cash discount to the buyer for payments. The volume financing depends on the factors such as -

a) Terms of Trade Credit.

b) Reputation of the purchasing business.

c) Financial position of the seller and

d) Volume of purchase to be made by the buyer.

The firm must balance the advantage trade credit as a discretionary source of financing without any explicit cost against the cost of losing of cash discount, the possibility of deterioration in reputation of trade credit and the increased purchase price of the product.

2. COMMERCIAL BANKS :

The commercial banks provide only short term credit to the business except medium term finance to some extent. Commercial banks make advances to the customers in the following forms.

i) Loans :

A loan is a kind of advance made with or without security. In the case of a loan, the banker makes a lump-sum payment to the borrower or credits his deposit account with the money advanced. It is given for a fixed period at an agreed rate of interest. Repayment may be made in installments at the expiry of a cretin period. Loan may be a "term loan" or a "demand loan".

ii) Cash Credit :

A cash credit is an arrangement by which a banker allows his customers to borrow money up to a certain limit. Cash credit arrangements are usually made against the security of commodities hypothecated or pledged with bank.

iii) **Hypothecation :**

In case of hypothecation, the possession of goods is not given to the bank. The goods remain at the disposal and in the godown of the borrower. The bank is given access to goods whenever it so desires. Such an advance is granted by the Bank only to a person in whose integrity and confidence is guaranteed.

iv) **Pledge :**

In case of the pledge the goods are placed in the custody of the bank with its name on the godown, where they are stored. The borrower has no right to deal directly with them, without the knowledge of the bank.

v) **Overdrafts:**

The customer may be allowed to overdraft facility, if the requires temporary accommodation. This bank credit is however for a short term only.

vi) **Bills Discounted and Purchased :**

The banks also give advances to their customers by discounting their bills. The net amount after deducting the amount of discount is credited to the account of the customer. The bank may discount the bills with or without security from the debtor in addition to the personal security of one or more persons already liable on the bill.

3. ACCRUAL ACCOUNTS :

Accrual accounts are spontaneous sources of financing, since they are self generating. The most common accrual accounts are wages and taxes. In both cases, the amount becomes due but is not paid immediately. The time lag between receipt of income and making payment for the expenditure incurred in earning that income helps the business in meeting some of its short term financial requirements.

B) SQUARES OF LONG TERM FINANCE :

A new business has only external sources of finance. However, an existing business can generate income through its internal sources. Two important sources of internal financing are depreciation and retained earnings.

1. Depreciation as a Source of Finance :

The ward depreciation signifies decrease in the value of asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. There is lot of controversy among academicians and business executives regarding treatment of depreciation as a source of funds. The depreciation being a non cash item of expenses does not affect the working capital of the firm and as such, not at all source of finance.

Validity of the above arguments cannot be questioned, but it can also not be denied that as a non cash expense, depreciation does not represent any cash outlay with the result that part of the profits adjusted for depreciation can be used by management to increase any of the current assets or pay taxes dividend etc.

2. Financing Through Retained Earnings :

The retained earnings are the earnings of a concern, which are retained in the business. They constitute the sum total of those profits which have been realised over the years since incorporation and which have been realised over the years since incorporation and which have been reinvested in the business rather than distributed in the form of dividend.

The accumulation of earnings is a dynamic process and takes several years, and it is a accelerated with profits and de-accelerated with losses. The process of creating internal savings and their utilisation in business is referred to as ploughing back profits.

This is strictly not a method of raising finance but refers to accumulation of profits by a company to finance its developments activities or repay loans. It is also known as internal financing.

This method of raising finance for a company is very useful because on the one hand, it does not cost any thing to the company and on the otehr hand, it strengthens the financial position of the company.

2.5 INVESTMENT OF FUNDS :

After having raised the finance through different sources, the next important task before the finance manager is the profitable deployment of the funds raised. The modern function of finance function includes both raising of finance and its proper utilisation. The funds raised are utilised for purchasing fixed assets and current assets. The investment in the fixed assets is known as long term investment and investment in current assets is known as short term investment.

a) Investment in Fixed Assets :

Fixed assets are those which are of a somewhat fixed or permanent nature (life expectancy of more than one year) and are used by a business in its normal operations. They do not include items offered for sale. Fixed assets include building machinery and equipments. Fixed assets management is the most important task which a management has to face in its day-to-day situations and is important for following reasons.

i) There is a risk involved in fixed assets because of their longer life.

ii) Fixed assets have usually a relatively high cost.

iii) Fixed assets create problem of acquisition and replacement. The main purpose of acquisition is to increase existing capacity. Replacements are the assets which take the place of existing assets with comparable capacity. The purchase of fixed assets is of particular significance to business firms because the amount involved is relatively large and represents commitments for relatively long period of time.

iv) There is greater tendency to make use of machines and invest more and more fixed assets. the use of efficient machinery is necessary for economies of scale particularly in condition of increasing competition. Due to. the technological charges, the investment in fixed assets is likely to increase for old assets become out dated and many have to be replaced.

The decisions regarding investment in fixed assets is usually known as capital budgeting. Capital budgeting may be defined as the decision making process by which a firm evaluates the purchase of major fixed assets including building, machinery and equipment. It is a process by which available cash and credit resources are allowed among competitive long term investments opportunities so as to promote the greatest profitability of the business over a period of time. It refers to the total process of generating evaluating, selecting and following up on capital expenditure alternatives.

Usually, the longterm sources of finance such as retained earnings are utilised for purchasing fixed assets. The business must have some fixed assets without which it cannot carry its operations smoothly.

b) Investment in Current Assets :

Every concern is required to invest some part of its fund is current assets. These assets are those which can be converted into cash within an accounting period (or operating cycle) an include cash, short term securities, debtors bills receivables and stock (inventory). The investment in current assets refers to as gross working capital. The net working capital refers to as the difference between current assets and current liabilities. Every business should maintain a sound working capital position and these should be optimum investments in working capital.

Usually, shorterm financial sources are utilised for investment in current assets. The usual sources of financing for current assets are the following.

i) Bank loan,

ii) Trade credit and other payable

iii) Provision for taxation.

iv) Depreciation provision.

2.6) PROFITABILITY ANALYSIS USE OF GROSS PROFIT/NET PROFIT RATIO :

Lord Keynes remarked "Profit is the engine that drives the business enterprise. It is indeed a magic are that mirrors all aspects of entire business operations including the quality of output".[1] The statement shows the importance of profit in survival of the business enterprise. Therefore, management efforts are always aimed at maximising profits and minimising losses. The efficiency of management is gauged in the 'test-tube' of profitability. According to Duk and Jervi, "The principal motivating force behind conducting business is profit, perhaps most important reason for keeping accounts is the content of such record which enables measurement of performance and progress of the enterprise".[2]

"The profitability is an ability an of given investment to earn a return from its use". Profitability is considered, to a great extent, to be one of the main criteria to judge the management and the success of management in maximising profits or minimising losses, if any.

RATIO FOR PROFITABILITY ANALYSIS :

Importance of profitability analysis has further been heightened in recent years because it helps in critically analysing and interpreting current and prospective earning capacity of business enterprise. In the present study, for analysing profitability of selected business agency, the following ratios have been made use of

A) Gross Profit Ratio :

The ratio reflect the efficiency with which the business produces each unit of product. The ratio is calculated as under.

$$\frac{\text{GROSS PROFIT}}{\text{SALES}} \times 100$$

It is the ratio which is most commonly employed by accountants for comparing the earnings of business for one period with those of other or earnings of one concern with those of another in the same business. It indicates the degree to which selling prices of goods per unit may decline without resulting in losses on operations for the firm.

A high gross profit ratio as compared with that of the other firm in the same business implies that the business in question produces its at lower cost. It is a sign of management.

A low gross profit ratio may indicate unfavourable purchasing and make-up-policies, the inability of management to develop sales volume, theft, damage, bad maintenance decrease in cost of goods etc.

B) Net Profit Ratio :

The ratio shows the percentage of net profit to sales. The net profit margin ratio is arrived t by dividing the net profit by sales, which indicates managements efficiency in manufacturing, administering and selling the products. Higher ratio indicates higher proportion of profit in a rupee sale. The business enterprise having high net margin ratio can adjust with adverse market situation like fall in prises, low demand and rising cost of production.