CHAPTER I

INTRODUCTION AND RESEARCH METHODOLOGY

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1. A INTRODUCTION

Finance is life blood of any business. It is essential for carrying the business. Without finance we can not run any business. Finance is the art and science of managing money. Financial management is concerned with the duties of financial managers in the business firm. The financial management function covers decision making in three-related areas viz., investment including working capital management, finance and dividend policy. Financial Management is an integral part of the overall management of the firm.

Every organisation needs capital to meet its short - term and long-term needs. The word "Capital" generally refers to the investment of the owner or owners in his or their business enterprise, raised either through their own contribution or through other means. The capital contributed is then converted into or utilised for acquisition of fixed assets such as land, building, fixtures, plant and machinery etc. Further funds can be obtained from internal sources such as sales and reserves or from external sources through issue of shares, loans, debenture, advances, and so on. These funds are needed in order to meet the fixed capital or working capital requirements. Fixed capital is that part of capital, which is needed for purchase of assets such as land, building, plant and machinery, etc. This is also known as long -term capital, which is acquired for the sake of using assets to earn profits. Besides fixed capital, a business organisation also needs capital for short-term use to meet the routine expenses for supplementing the needs of the organisation in productive utilisation of fixed assets, such as acquisition of raw material for day to day production, daily or short - term overhead expenses, labour cost, administrative and general expenses. It is referred to as "Working Capital".

A-1 WORKING CAPITAL

Working capital is an important element in business operations. It is like blood constantly circulating in the body to provide the fuel required for all the parts of the body to generate energy for sustaining life. Working Capital represents liquid assets that are convertible into cash in the shortest possible time to make cash funds available when required, in order to meet the routine expenses of the business towards earning profits. Without such liquid funds daily production and operational needs of the organisation can not be satisfied. Liquid funds have to be generated out of current assets, loans and advances given amount recoverable in cash and short-term investments and assets which are convertible into cash in a short span of time, besides cash and bank balances. Fixed assets should not be used for generation of working capital.

Working capital can be defined as that part of the total capital which is required for daily working of the business. Working capital is also known as circulating capital, because it starts with cash and ultimately results in cash after completing the cycle. Cash is converted into stock of goods, later the goods are sold, sale of goods creates debtors and bills receivables and finally they are turned in to cash.

A-2 DEFINITION OF WORKING CAPITAL

1. "Working Capital is the amount of funds necessary to cover the cost of operating the enterprise". - Shubin
2. "Circulating capital means current assets of a company that are changed in the ordinary course of business so one form into another as for example from cash to inventories, inventories to receivables and receivables into cash." - Gerstenberg

Working capital is also defined as "excess of current assets over current liabilities." This concept of working capital is useful to know whether the current assets are sufficient to meet the current liabilities i.e. the short term solvency of the business is sound or questionable.

A-3 FACTORS DETERMINING WORKING CAPITAL REQUIREMENTS

A company as a general policy wants to hold in balances as small as quantity of working capital as possible so long as undue solvency risks are not faced. This is a logical approach indicating that working capital is a means to an end and not an end in itself. Quantitative amounts of working capital can hardly be set for individual firms. The corporate management has to consider the various factors in making decision regarding the amount of working capital. An appraisal of these would provide guidance to management in estimating future working capital needs.

1) Nature of Business

A company's working capital requirements are basically related to its nature business. Public utilities require low working capital because of cash nature of their business and partly of their selling a service instead of a commodity and there is no need of maintaining big inventories. On the contrary, trading concerns have to invest proportionately high amounts in current assets. The industrial units also require a large amount of working capital though it varies from industry to industry because of the lack of uniformity in the asset structure of various industries.

2) Seasonal Fluctuation

During the busy season, a business requires larger working capital, while during the slack season a company requires lower working capital. Similarly during the period of boom as well as of depression larger working capital is required.

3) Manufacturing Process

If the manufacturing process requires a longer period because of it complex character, more working capital is required. Similarly, the longer the merchandising cycle-cash to inventory to sale to receivables to cash greater is the need for working capital. Shorter the spread between production and sales, smaller shall be the working capital requirement.

4) Growth and Expansion of Business

If expansion of the business is being made at normal rate, retained profits can be used. However, for rapid growth such profits are not sufficient and this necessitates, the provision of more working capital.

5) Turn-over of Circulating Capital

The speed with which the circulating capital completes its round i.e. conversion of cash into inventory of raw material and stores, raw material into finished goods, finished goods into book debts or account receivables and book debts into cash account, plays an important role in judging the adequacy of working capital. If the speed of circulating capital is high then less working capital is required.

6) Business Cycle Fluctuations

Requirements of working capital of a company vary with the business variation. The inflationary conditions create demand for more and more capital, the working capital under such conditions increases. During deflationary conditions huge amount is blocked up into inventories, rate of sale is low and working capital adjusted is high.

7) Terms of purchase and sale

The requirement of working capital depends upon the terms of purchase and sale. Cash purchase requires more working capital as compared to credit purchases. Similarly policy of credit sales needs more working capital than that of cash sales. Cash purchases and credit sales require still more working capital as compared to credit purchases and credit sales. On the contrary, cash sales and credit purchases require less working capital.

8) Dividend Policy

A desire to maintain established dividend policy may affect working requirement. Often changes in working capital lead to an adjustment of dividend policy. A shortage of working capital often acts us a powerful reason for reducing a cash dividend. A strong position may justify continuing dividend payment at least for a while, even though earnings are insufficient to cover the payment

9) Large Inventories

Some of the companies are required to maintain large quantities of raw materials work in progress and finished goods required for the production. The reasons for keeping large reserves of raw materials may be seasonal nature of raw materials, long distance, scarcity etc. In such case the working capital needed is comparatively more.

10) Other Factors

In addition, absence of co-ordination in production and distribution policies in a company may result in a high demand for working capital. Secondly, the absence of specialisation in the distribution of products may increase the need of working capital for a concern. Thirdly, if the means of transport and communication in a country are inadequate the industries may face a great demand for working capital in order to maintain big inventory of raw materials and other accessories. Fourthly, the import policy of the government may affect the requirement of working capital for the companies.

A-4 SOURCES OF WORKING CAPITAL

Following are the different sources of working capital.

a) Net gains from operations

Net profits constitute a potential permanent source of working capital funds from current operations. Since funds acquiring due to the depreciation are usually expected to be reinvested at some later date in replacements and additions of fixed assets, this is most desirable source of working capital as it does not create any financial burden the business. The main limitation of this source of capital is that it cannot produce much funds on short notices.

b) Sale of Fixed Assets

Sale of fixed assets is an occasional and irregular source and management cannot usually depend on fixed assets for working capital even to meet emergency needs because of the unfavourable effect on operations and profits.

c) Raising long-term debt

Capital borrowing is a source of working capital that can be planned with certainty but these funds eventually have to be returned to the creditors and that to out of working capital.

d) Additional issue of shares

Funds raised from the sale of shares may be a potential permanent source of working capital funds in addition to net profit. These share issues may not add to interest burden like long-term debt but they exert a potential demand for dividends and the use of this source may mean sharing the ownership in the business with new investors.

e) Retirement of current liabilities below book value

Retiring current liabilities below book value is not normal procedure in business except in a few cases where creditors may agree to accept a payment less than the face amount of debt. Retirement of current liabilities results in increase of net working capital.

f) Deferred payment of taxes

Deferred payment of taxes can only be a temporary source of working capital. Taxes are not paid immediately day to day but the estimated liability for them is indicated in the balance sheet. There is a certain period of time during which business can hold and may use these funds. But the quarterly advance payments of tax have diminished the significance of income tax accruals as a source of working capital.

g) Trade Credit

Trade credit, refers to the credit extended by the supplier of goods and services in the normal course of business. According to trade practices cash is not paid immediately for purchases but is paid after an agreed period of time. This deferral of payment is a source of finance for credit purchase. Trade credit is easily available. It is a flexible and spontaneous source of finance. The availability and magnitude of trade credit is related to the size of operations of the firm in terms of sales or purchases.

h) Bank Credit

Working Capital finance is provided by banks in five ways.

1) Cash Credits / Overdraft –

Under cash credit / overdraft form the bank specifies a predetermined borrowing limit. The borrower can borrow upto the stipulated credit limit as per his requirements. Repayments can be made whenever as per borrowers convenience or as per the turns of cash credit or over draft.

2) Loans

Under this arrangement the entire amount of borrowing is credited to the current account of the borrower. The borrower has to pay interest on the total amount. The loans are repayable on demand or in periodic installments. They can also be renewed from time to time.

3) Letter of credit

Letter of credit is an indirect form of working capital financing and banks assume only the risk, the credit being provided by the supplier himself. The purchaser of goods on credit obtains a letter of credit from a bank. The bank undertakes the responsibility to make payment to the supplier in case the buyer fails to meet his obligation.

4) Bills Discounted

Bill finance is a source of working capital financing. A bill arises out of a trade sale-purchase transaction on credit. The seller of goods, draws a bill on the purchaser of good, payable on demand or after a certain period. On acceptance of the bill by the purchaser, the seller may discount it to the bank for discount. On discounting the bill the bank gives the funds to the seller and on maturity it collects the amount from the purchaser.

5) Hypothecation

Under this mode of security the bank provides credit to borrowers against the security of movable property, usually inventory of goods. The goods hypothecated, however, continue to be in the possession of the owner of these goods. The rights of the lending bank depends upon the terms of the contract between the borrower and the lender.

I) Commercial Paper :

Commercial paper is a short-term unsecured negotiable instrument. It is issued on a discount on face value basis but it can also be issued in interest bearing form. It is flexible in terms of maturities which can be adjusted to match the cash flow of the issuer. A well-rated company can diversify its short-term source of finance from banks to money market at cheaper cost. The investors can get higher returns than what they can get from the banking system. The commercial papers are unsecured and there are not limitations on the use of funds through them. As negotiable instruments they are highly liquid.

J) Factoring

Factoring is another source of working capital. Factoring is a unique financiai innovation. It is both a financial as well as management support to a client. It is a method of converting a non productive asset into a productive asset. For a number of companies cash may become a problem if it takes a long time to receive payment for goods and services supplied by them. Such current asset in the balance sheet is infact liquid but serves no business purpose. A factor makes the conversion of receivables into cash. Factoring is legal relationship between financial institution (the factor) and a business concern (the client).

A-5 STATEMENT OF CHANGES IN FINANCIAL POSITION

Introduction :

Balance sheet and Profit and Loss account are the traditional basic financial statements of a business enterprise. The balance sheet gives a static view of the sources and uses of finances. But it does not indicate the causes of the changes or movement of finance between two periods. In operational terms balance sheet fails to answer question such as.

- What are the factors responsible for the difference in owners equity, assets and liabilities of the firms at two dates of consecutive balance sheets ?

- Whether long - term sources have been adequate to finance fixed asset purchases?
- Whether the firm possesses adequate working capital and cash ?
- Does the firm have adequate liquid assets ?
- What is the amount of funds generated from operations?
- What is the amount of funds generated from investment and financing activities ?
- Whether the liquidity position of the firm has improved ?

Therefore, an additional statement is needed to show the changes in assets and liabilities and owners equity between dates of two balance sheets.

A-6 MEANING OF CHANGES IN FINANCIAL POSITION

The statement of changes in financial position (SCFP) statement measures the changes that have taken place in the financial position of a firm between two balance sheet dates. It summaries the sources from which funds have been obtained and uses to which they have been applied. As a statement of sources and uses of funds, drawing on the information contained in the basic financial statement, it shows the source of funds and application of funds during the period. The changes in financial position could be related to several different concepts of funds. The two most common usages of the term funds are cash and working capital. The SCFP would explain the changes in cash or working capital. Accordingly, there are two statements that is, statement of changes in cash (cash flow statement) and statement of changes in working capital. (Sources and uses statement or funds flow statement).

1. Funds Flow Statement

A Balance Sheet gives a static view of the sources and uses of finances. But it does not indicate the causes of the changes or movement of finance between two periods. The success or failure of any business depends upon the availability of funds and their better utilisation. The funds flow statement reveals the source from which the funds are made available and how they are utilised or applied. The statement showing sources and uses of funds popularly known as the 'Funds Flow Statement' is a condensed report of how the activities of the business have been financed and how the financial resources have been used during the period covered by the statement. It is an operating statement. However, it performs a different function from the income statement which is primarily a presentation of revenue and expenses items and computation of the net income for the periods. The funds flow statement is a report of the financial operation of a business undertaking. It shows flow of funds into and out of a business.

The funds flow statement is not a supporting schedule to the balance sheet, the income statement or the statement of allocation of earnings, although it is technically based upon the same accounting data and ties into these financial statements. It is, instead a complementary statement, an important report to present information which cannot be obtained from other financial statement.

In the words of Anthony "The funds flow statement describes the sources from which additional funds were derived and the uses to which these funds were put."

Foulke defines the funds-flow statement as "Statement of sources and application of funds is a technical device designed to analysis the changes in the financial condition of a business enterprises between two dates." This statement is also known as "Funds Received and Disbursed Statement" Statement of funds supplied and applied.

2. Meaning of Fund

The term fund is used in three different meanings : In its narrow sense it is taken as 'Cash' When it is taken as cash the statement prepared is called cash-flow statement" which shows incoming and outgoing of cash only. All receipts of cash from the sources of funds, whereas all payments in cash from the application or uses of funds, are shown.

This is a narrow concept, because all movements which affect the financial position of a business, but which are of none cash nature outside the scope of the term 'fund'.

The term 'fund' in border sense covers all assets and all liabilities. The entire assets side shows uses of funds, whereas the entire liabilities side show the sources of funds.

The above two concepts are the two extremes, and the most accepted concept is the "Working Capital Concept." This concept covers all movements that affect the working capital. Any movement which increases working capital is a source of fund and any movement which decreases working capital is an application of fund.

a) Flow of Fund

In simple words, it means movement of funds i.e. incoming of funds from different sources and their outgoing i.e. use for different purposes, such as purchase of assets or repayment of liabilities etc. Thus a flow of funds effects change in the amount of fund i.e. working capital.

b) Inflow of Funds or Sources of Funds

If a business transaction results in increase in the funds i.e. working capital, it is an inflow or source of funds e.g. sale of fixed asset results in increase in cash i.e. increase in working capital and hence it is an inflow or source of funds.

c) Outflow of funds or Application of Funds

When a business transaction reduces the working capital, it is said to be an 'outflow' or application of funds e.g. repayment of debentures. Since this transaction results in reduction of cash i.e. working capital, it is outflow of funds.

3. Objectives

The funds flow statement is used widely by financial analysts, credit granting institutions, and financial managers. Funds flow statement is a useful tool of financial analysis. The basic purpose of this statement is to indicate on a historical basis where cash came from and where it was used. It is often regarded as a counterpart to the cash budget. The cash budget is a projection into the future whereas the funds flow statement is historical. The funds flow statement contributes materially to the financial aspects of the business. The following are objectives of funds flow statement :

1) To know the increase and decrease in working capital
2) To know the expansion of the assets
3) To know the distribution of profit
4) To know the amount of the debts requirement
5) To know the financial position of the business

The principal material used in the preparation of a funds flow statement ordinarily consists of comparative balance sheets with the net changes which have taken place in the various items during the period covered by the statement. This statement organises the material after some deletions, combinations and additional analysis and reclassification into two principal groups

Comparative funds flow statements, covering several years of operations in a company enable the reader to obtain useful information on the financial methods used in the past, dividend policies followed and the contribution of funds derived from the operations to the growth of the company. They also provide reliable clues as to future financial requirements, of the firm.

The funds flow statement is a report of the financial operations of the company. Through this statement cannot replace the income statement but it provides an equally significant analysis of the financial phase of business operations. This statement is also more comparable with those of other companies than are the balance sheets and income statements since some of the major variations in accounting procedure are eliminated in the calculation of the funds provided from operations.

4. Advantages of Funds- flow Statement

1. A useful tool for financial management is funds-flow study. The balance sheet is only a list of assets and liabilities indicating the financial position at a certain point of time. Its nature is of historical character and it does not meet the dynamic requirement of the financial management. A financial executive must know the flows of funds indicated by the changes in the figures of the Balance Sheet. this purpose is served by the funds flow statement.

2. It helps in the formation of realistic dividend policy

Some times a firm has sufficient profits available for distribution as dividend but yet it may not be advisable to distribute dividend for lack of liquid or cash resources. In such cases funds flow statement helps in the formation of a realistic dividend policy.

3. It helps to proper allocation of resources

The resources of a concern are always limited and it wants to make the best use of these resources. A projected funds flow statement constructed for the future helps in making managerial decisions. The firm can help the development of its resources and allocate them among various applications.

4. It act as future guide

A projected fund flow statement also acts as a guide for future to the management. The management can come to know the various problems it is going to face in near future for want of funds. The firms future needs of funds can be projected well in advance and also timing of these needs. The firm can arrange to meet these needs more effectively and avoid future problems.

5. It helps in apprising the use of working capital

A funds flow statement helps in explaining how efficiently management has used its working capital and also suggests way to improve working capital position of the firm.

6. It helps to knowing credit worthiness of a firm

The financial institutions and banks such as State Financial Corporation, Industrial Development Corporation, Industrial Financial

Corporation India etc, all ask for funds flow statement constructed for a number of years before granting loans to know credit worthiness an paying capacity of the firm.

5. Limitations of Funds Flow Statement

Funds flow statement has number of uses however it has certain limitations also which are as follows

1. Fund flow statement can be a substitute for an income statement or a balance sheet. It provides only some additional information as regards changes in working capital.
2. It cannot reval continuous change.
3. It is simply rearrangement of data given in the financial statement.
4. It is essentially historic in nature and projected funds flow statement can not be prepared with much accuracy.
5. Changes in cash are more important relevant for financial management than working capital.

6. Sources and Uses of Working Capital

1) **Sources of Working Capital**	2) **Uses of Working Capital**
a) Funds from business operations	a) Losses from operations
b) Other incomes	b) Purchase of non-current assets
c) Sales of Non-current assets	c) Redemption of debentures and or preference shares
d) Long term borrowing	
e) Issue of additional equity capital and preference share capital.	d) Dividends to shareholder.

7. Funds from Operation

The Profit and Loss figure as shown in the profit and loss account of the firm, does not indicate the quantum of working capital provided by business operations. The Profit and Loss account contains a number of write-offs and other adjustments which do not involve any corresponding movement of funds. Therefore, appropriate adjustments are to be made in respect of these items shown in profit and loss account a arrive at the funds from business operations. 1) All such expenses which have been deducted from revenue but do not reduce working capital are to be added back e.g. depreciation on fixed assets. 2) Such items as have been added to revenue but have not contributed to the working capital are to be subtracted e.g. appreciation of land and building and 3) All such revenue which are not directly caused by business should be also deducted and shown separately in the statement

Chart 1.1 Funds from Operations

Funds from Operations			**(Rs.)**
	Closing Balance of Profit and Loss A/c or Retained Earning (as given in the Balance Sheet)		xxx
	Add : Non-fund and Non-operating items which have been already debited to Profit and loss Account		
a)	Depreciation and Depletion		xxx
b)	Amortisation of Fictitious and Intangible Assets such as :	xxx	
	- Goodwill	xxx	
	- Patents	xxx	
	- Preliminary expenses	xxx	
	- Discount on issue of shares, etc.	xxx	xxx
c)	Appropriation of Retained Earnings, such as:		
	- Transfer of general reserve	xxx	
	- Divided equalisation fund	xxx	
	- Transfer to sinking fund	xxx	
	- Contingency reserve, etc.	xxx	xxx
d)	Loss on Sale of any Non-current (fixed) assets such as:		
	- Loss on sale of land and building	xxx	
	- Loss on sale of machinery	xxx	
	- Loss on sale of furniture	xxx	
	- Loss on sale of long-term investments, etc.	xxx	xxx
e)	Dividends including :		
	- Interim dividend	xxx	
	- Proposed dividend (if it is an appropriation of profits not taken as current liability)	xxx	xxx
f)	Provision for Taxation (if it is not taken as current liability)		xxx
g)	Any other non-fund/non-operating items which have been debited to Profit and Loss A/c		xxx
	(a)		xxx
	Less : Non-fund or Non-operating items which have already been credited to Profit and Loss Account		
1)	Profit or Gain from the Sale of Non-current (fixed) assets such as:		
	- Profit on sale of land and building	xxx	
	- Profit on sale of plant and machinery	xxx	
	- Profit on sale long-term investments, etc.	xxx	xxx
2)	Appreciation in the value of fixed assets, such as increase in the value of land if it has been credited to Profit and Loss A/c		xxx
3)	Dividends received		xxx
4)	Excess provision retransferred to Profit and Loss A/c or written off		xxx
5)	Any other non-operating item which has been credited to Profit and Loss A/c		xxx
6)	Opening balance of Profit and Loss A/c or Retained earnings (as given in the balance sheet)		xxx
	(b)		xxx
Funds Generated from Operations	*(a) – (b)*		xxx

SOURCE : FINANCIAL MANAGEMENT - RAVI M. KISHORE

9. Preparation of Funds-flow Statement

A schedule of changes in Working Capital is prepared to find out increase or decrease in working capital before preparing funds flow statement.

Table 1.1 Statement of Changes in Working Capital

Assets & Liabilities	Previous year Rs.	Current Year Rs.	Changes in Working Capital	
			Increase Rs.	Decrease Rs.
Current Assets				
Stock in Trade	XXX	XXX	XXX	XXX
Debtors	XXX	XXX	XXX	XXX
Cash Balance	XXX	XXX	XXX	XXX
Bank Balance	XXX	XXX	XXX	XXX
Prepaid Expenses etc.	XXX	XXX	XXX	XXX
Total (A)	**XXX**	**XXX**	**XXX**	**XXX**
Current Liabilities				
Sundry Creditors	XXX	XXX	XXX	XXX
Outstanding Expenses	XXX	XXX	XXX	XXX
Bills Payable	XXX	XXX	XXX	XXX
Bank Overdraft etc.	XXX	XXX	XXX	XXX
Total B	**XXX**	**XXX**	**XXX**	**XXX**
Net Working Capital (A - B)	**XXX**	**XXX**	**XXX**	**XXX**
Increase / Decrease in Working Capital	XXX	XXX	XXX	XXX

SOURCE: ELEMENTS OF FINANCIAL MANAGEMENT – I.M.PANDEY

10. Funds Flow Statement

While preparing funds-flow statement, funds from operation, increase in non-current liabilities, non - operating (i.e. non-trading) incomes, such as sale of fixed assets dividends, rent etc. and decrease in working capital as shown as source of funds.

Loss from operations, redemption or repayment of non-current liabilities non-trading payments of dividends etc. and increase in working capital are shown as Application of funds. The statement may be prepared either in Report Form or in the Account From.

Table 1.2 Funds-Flow Statement (Account Form)

Particulars	Rs.	Particulars	Rs.
Sources of Funds		Application of Funds	
i) Funds from operation	XXX	i) Loss from operation	XXX
ii) Issue of share capital	XXX	ii) Redemption of shares	XXX
iii) Issue of debentures	XXX	iii) Redemption of Debentures	XXX
iv) Long-term loans taken	XXX		
v) Sale of investment and other fixed assets	XXX	iv) Repayment of long term loans	XXX
vi) Non-trading receipts eg. dividend received	XXX	v) Purchase of investment or other fixed assets.	XXX
vii) Decrease in working capital.	XXX	vi) Non-trading payments eg. payment of dividend income-tax etc.	XXX
		vii) Increase in working capital	XXX
Total	XXX	Total	XXX

SOURCE : FINANCIAL MANAGEMENT - RAVI M. KISHORE

Table 1.3 Funds-Flow Statement (Report From)

Sources of Funds	
i) Funds from operations	XXX
ii) Issue of Share Capital	XXX
iii) Issue of Debentures	XXX
iv) Long-term Loans	XXX
v) Sale of Investments / Fixed Assets	XXX
vi) Non-Trading Receipts	XXX
vii) Decrease in Working Capital	XXX
Total	**XXX**
Application of funds	
i) Loss from Operations	XXX
ii) Redemption of Shares	XXX
iii) Redemption of Debentures	XXX
iv) Repayment of Long-Term Loans	XXX
v) Purchase of Investments / Fixed Assets	XXX
vi) Non-trading Payments	XXX
vii) Increase in Working Capital	XXX
Total	**XXX**

SOURCE : FINANCIAL MANAGEMENT – RAVI M. KISHORE

A-7 CASH FLOW ANALYSIS

Cash flow is another tool of investment analysis. The expression 'Cash Flow' in the literature of investment and security analysis is usually an equivalent of funds provided by operations in the typical statement. 'Cash' in financial analysis means net income after adding back expenses items which currently do not use funds, such as depreciation. This measure is typically referred to as internally generated funds or cash throw-off and is more commonly known as the cash flow.

The term 'Cash flow' however is neither cash nor flow. The net income can hardly be computed on a cash basis. Adding back such items as depreciation does not convert the net income to something which can properly be called cash flow or income. The word flow is inappropriate since the amount involved as the balance or the result of a flow many transactions rather than being a measure of flow itself. The term cash flow seems to be accepted in financial literature as a convenient symbol.

The concept of cash flow can be used effectively as one of major factors in judging the ability to meet debt retirement requirements to maintain regular dividends and to finance replacement and expansion costs. The portion of the cash flow associated with the accounting for depreciation and similar items is merely part of the cycle of i) investment in an asset ii) recovery of the cost from revenue earning operations and iii) reinvestment unlike the net income this portion of cash flow has no effect upon the shareholders equity or net worth. Only the net income can properly be compared with the shareholders investment in arriving at a measure of the success of the business operation.

7.1. Advantages of Cash Flow Statement :

1. Helps in efficient management

One of the most important function of the management is to manage cash resources in such a way that adequate cash is available to meet the liabilities. A cash flow statement helps in planning and coordinating the financial operations of the business effectively .

2. Helps in internal financial management

The cash flow analysis helps in exploring the possibility of repayment of long term debts which depends upon the availability of cash.

3. Shows the movement of cash

The cash flow statement shows the increase and decrease in cash. It helps the financial manager in explaining movement of cash.

4. Discloses success or failure of cash planning.

Comparison of actual budgeted cash flow statement will disclose the failure or success of the management in managing cash resources.

5. Helps to determine cash flows

Cash flow statement helps the management to determine the inflows or outflows of cash from operation and the amount of cash required to be raised from other sources to meet the future needs of the business.

6. Supplemental to funds flow statement

Cash flow analysis supplements the analysis provide by funds flow statement as cash is a part of working capital.

7. Better tool of analysis

For payment of liabilities which are likely to be matured in near future, cash is more important. The cash flow statement is a better tool of analysis than funds flow statement for short – term analysis.

7.2. Limitations of Cash Flow Statement

The cash flow statement has a number of uses, however, it has certain limitations as follows:

1. Misleading Inter - Industry Comparison

Cash flow statement does not measure the economic efficiency of one company in relation to another. Usually a company with heavy capital investment will have more cash flow. Therefore, Inter - Industry Comparison of cash flow statement may be misleading.

2. Misleading Inter - Firm comparison

The terms of purchase and sales will differ from firm to firm therefore inter firm comparison of cash flow may be misleading.

3. Influenced By Changes In Management Policies

The cash balances as disclosed by cash flow statements may not represent the real liquid position of business, cash can be influenced by purchases and sales policies, by making certain advance payments.

4. Can Not Be Equated With Income Statement

Cash flow statement can not be equated with the income statement. An income statement take into account both cash as well as non cash items.

5. Not A Replacement of Other Statement

Cash flow statement is only a supplement of funds flow statement and can not replace the Income Statement or Funds flow statement as each one has its own function or purpose of preparation.

7.3. Preparation of Cash Flow Statement

a) Cash from Business Operations

Funds from business operations under working capital concept are based on accrual accounting concept. But under the cash concept of funds, obviously, the cash basis of accounting is to be used. Only cash sales and cash receipts from debtors against credit sales are recognized as source of cash. Similarly cash purchases and cash payments to suppliers for credit purchases are regarded as the use of cash.

Thus, every item in the Profit and Loss account is taken as per cash approach. Some of the items of adjustment of profit and loss account in the cash flow approach would be the same as in the statement of funds flow. Cash is only one of the current asset and is part of the net working capital. Therefore, the changes in all of the other current assets and in the current liabilities must be analysed in relation to their effect on cash. The rules for relating the changes in current assets and current liabilities to the profit and loss account in the computation of a flow of cash from operations are mentioned below.

1) All the increases in current assets excluding cash and decrease in current liabilities which increase working capital decrease cash. The decrease in current liabilities takes place when they are paid in cash. For instance decrease in creditors, bank overdrafts, bills payable and dividend payable will occur due to their cash payment.

2) All decrease in current assets other than cash and increases in current liabilities which cause a decrease in working capital increase cash. Debtors would decrease because cash collections from them. Inventories would decrease because cost of goods sold is more than cost of goods purchased.

   Cash flow from business operations.

b) Definitions associated with cash flow

1) Cash – It consists of cash in hand a demand deposit with banks.

2) Cash Equivalents : These are short term highly liquid investments that are readily convertible into known amount of changes in value. They have short maturity.

3) Cash Flows : These are inflows and outflows of cash and cash equivalents.

c) Operating Activities

Cash inflows from operating activities primarily accure from the major revenue producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.

- Cash receipts from the sale of goods and rendering of services.
- Cash receipts from royalties, fees, commission and other services.
- Cash payment to suppliers for goods and services.
- Cash payments to and on behalf of employees.
- Cash receipts and cash payments of an insurance enterprise for premiums and claims annuities and other policy benefits.
- Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities.

- Cash receipts and payments relating to future contracts forward contracts option contrats.

d) Investing Activities

The investing activities relate to the acquisition and disposal of long - term assets and other investments not included in cash equivalents. Their separate disclosure is important as they represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. The items covered under this category of activities are follows.

- Cash payment to acquire fixed assets (including intangible) These payments include those relating to capital research and development cost and self constructed fixed assets.
- Cash receipts from disposal of fixed assets.
- Cash payments to acquire share warrants or debt instruments of other enterprises and interest in joint venture.
- Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interest in joint ventures.
- Cash advances and loans made to third parties.
- Cash receipts from the repayment of advances and loans made to third parties.

e) Financing Activities

The financing activities report the changes in the size and composition of share capital and debt of the enterprise. Their separate disclosure is useful in predicting claims on future cash and cash flow by provider of funds (both capital and borrowing) to the enterprise. Examples of cash flow arising from financing activities are as follows.

- Cash proceeds from issue of debentures, loans, bonds and other short term or long term borrowing.
- Cash proceeds from issue of shares or other similar instruments.
- Cash repayments of amount borrowed.
- Buy-back of shares.
- Redemption of preference shares.
- Dividend / interest paid.

Table 1.4 Statement of Cash Flow

Statement of cash flow as per direct method is as follows

CASH FLOW STATEMENT (DIRECT METHOD)		
Cash flows from operating activities		
Cash receipt from customers		xxx
Cash paid to suppliers and employees		(xxx)
Cash Generated from operations		xxx
Income –tax paid		(xxx)
Cash flow before extra ordinary items		xxx
Net cash flow from operating activities	a	xxx
Cash flows from Investing Activities		
Purchases of fixed assets		(xxx)
Proceeds from sale of equipment		xxx
Interest received		xxx
Dividend received		xxx
Net cash flow from investing activities	b	xxx
Cash flows from Financial Activities		
Proceeds from issuance of share capital		xxx
Proceeds from long term borrowings		xxx
Repayment of long term borrowings		(xxx)
Interest paid		(xxx)
Dividend paid		(xxx)
Net cash flow from financing activities	c	xxx
Net Increase (Decrease)in cash and cash equivalents (a+b+c)		xxx
Cash and cash equivalents at beginning of period		xxx
Net cash and cash equivalents at end of period		xxx

SOURCE : FINANCIAL MANAGEMENT RAVI M. KISHORE

1. B RESEARCH METHODOLOGY

The Research methodology applied for the study is as follows

B-1 A STATEMENT OF PROBLEM

The statement of problem is A Critical Study of Sources and Application of Funds With special reference to Menon Bearings Limited, Gokul Shirgaon, Kolhapur.

B-2 SIGNIFICANCE OF STUDY

With the help of funds statement a finance officer can ensure that the business will have funds when ever required and will be utilized effectively when available.

It is an essential tool of financial analysis, it is a major instrument used for analysing the financial problems and determining the long range financial policies of the business enterprise.

It helps the financial manager in planning the intermediate and long term financing of the business. it is an analysis of the major sources of funds which reveals the internal and external sources.

It is a test of effective use of working capital by the management during a particular period.

B-3 OBJECTIVES OF STUDY :

1. To study the nature of business activities of Menon Bearings Limited, Gokul Shirgaon, Kolhapur
2. To study changes in the firms working capital position.
3. To prepare cash flow statement and analyse the changes in cash position of the firm.

4. To study the changes in financial position of the firm with the help of funds flow statement.
5. To suggest ways and means to improve its efficiency in receiving and applying funds.

B-4 DATA COLLECTION

a) The Primary Data

The primary data required for the study is collected by using questionnaire and interview methods.

b) The Secondary data

The Present research work is dependent largely on secondary data. The records of the company is the main source of data required for the study. In addition to the company records other published data has been used for analysing the sources and application of funds of the company. This includes reference book, journal, periodicals and other published material.

B-5 ANALYSIS AND INTERPRETATION OF DATA

The data in financial statements of the company is analysed and interpreted by preparing the Funds Flow Statement. Cash Flow Statement.

B-6 PRESENTATION OF DATA

The data is presented in various chapters. The proposed chapter scheme of the study is as follows.

CHAPTER SCHEME

Chapter I	:	Introduction and Research Methodology
Chapter II	:	Profile of Menon Bearings Ltd. Gokul, Shirgaon, Kolhapur.
Chapter III	:	Data Presentation and analysis
Chapter IV	:	Findings and Suggestions

B-7 LIMITATIONS OF THE STUDY

The present study is confined to the Sources and Application of funds of one unit viz. Menon Bearings Ltd. Gokul Shirgaon, Kolhapur. Due to time constraint the period of study is restricted to five years from 2001-2002 to 2005-2006.

The researcher has relied upon the secondary data made available by the company. Even though the present study is confined to one unit, there is a vast scope, for further research in the finance area and the scope of the study may be extended to the engineering industry in Kolhapur District.