Financial management Notes

FINANCIAL MANAGEMENT

Financial management is an academic discipline which is concerned with decision-making. This decision is concerned with the size and composition of assets and the level and structure of financing. In order to make right decision, it is necessary to have a clear understanding of the objectives. Such an objective provides a framework for right kind of financial decision making. The objectives are concerned with designing a method of operating the Internal Investment and financing of a firm. There are two widely applied approaches, viz.

(a) profit maximization and

(b) wealth maximization.

The term '**objective'** is used in the sense of an object, a goal or decision criterion. The three decisions - Investment decision, financing decision and dividend policy decision are guided by the objective. Therefore, what is relevant - is not the over-all objective but an operationally useful criterion: It should also be noted that the term objective provides a normative framework. Therefore, a firm should try to achieve and on policies which should be followed so that certain goals are to be achieved. It should be noted that the firms do not necessarily follow them.

Profit Maximization as a Decision Criterion

Profit maximization is considered as the goal of financial management. In this approach, actions that Increase profits should be undertaken and the actions that decrease the profits are avoided. Thus, the Investment, financing and dividend also be noted that the term objective provides a normative framework decisions should be oriented to the maximization of profits. The term 'profit' is used in two senses. In one sense it is used as an owner-oriented.

In this concept it refers to the amount and share of national Income that is paid to the owners of business. The second way is an operational concept i.e. profitability. This concept signifies economic efficiency. It means profitability refers to a situation where output exceeds Input. It means, the value created by the use of resources is greater that the Input resources. Thus in all the decisions, one test is used I.e. select asset, projects and decisions that are profitable and reject those which are not profitable.

The profit maximization criterion is criticized on several grounds. Firstly, the reasons for the opposition that are based on misapprehensions about the workability and fairness of the private enterprise itself. Secondly, profit maximization suffers from the difficulty of applying this criterion in the actual real-world situations. The term 'objective' refers to an explicit operational guide for the internal investment and financing of a firm and not the overall business operations. We shall now discuss the limitations of profit maximization objective of financial management.

1) <u>Ambiguity:</u>
The term 'profit maximization' as a criterion for financial decision is vague and ambiguous concept. It lacks precise connotation. The term 'profit' is amenable to different interpretations by different people. For example, profit may be long-term or short-term. It may be total profit or rate of profit. It may be net profit before tax or net profit after tax. It may be return on total capital employed or total assets or shareholders equity and so on.

2) <u>Timing of Benefits:</u>
Another technical objection to the profit maximization criterion is that It Ignores the differences in the time pattern of the benefits received from Investment proposals or courses of action. When the profitability is worked out **the bigger the better principle** is adopted as the decision is based on the total benefits received over the working life of the asset, Irrespective of when they were received. The following table can be considered to explain this limitation.

3) <u>Quality of Benefits</u>
Another Important technical limitation of profit maximization criterion is that it ignores the quality aspects of benefits which are associated with the financial course of action. The term 'quality' means the degree of certainty associated with which benefits can be expected. Therefore, the more certain the expected return, the higher the quality of benefits. As against this, the more uncertain or fluctuating the expected benefits, the lower the quality of benefits.

The profit maximization criterion is not appropriate and suitable as an operational objective. It is unsuitable and inappropriate as an operational objective of Investment financing and dividend decisions of a firm. It is vague and ambiguous. It ignores important dimensions of financial analysis viz. risk and time value of money.

An appropriate operational decision criterion **for** financial management should possess the following quality.

a) It should be precise and exact.

b) It should be based on bigger the better principle.

c) It should consider both quantity and quality dimensions of benefits.

d) It should recognize time value of money.

Wealth Maximization Decision Criterion

Wealth maximization decision criterion is also known as Value Maximization or Net Present-Worth maximization. In the current academic literature value maximization is widely accepted as an appropriate operational decision criterion for financial management decision. It removes the technical limitations of the profit maximization criterion. It posses the three requirements of a suitable operational objective of financial courses of action. These three features are exactness, quality of benefits and the time value of money.

i) Exactness: The value of an asset should be determined In terms of returns it can produce. Thus, the worth of a course of action should be valued In terms of the returns less the cost of undertaking the particular course of action. Important element in computing the value of a financial course of action is the exactness in computing the benefits associated with the course of action. The wealth maximization criterion is based on cash flows generated and not on accounting profit. The computation of cash inflows and cash outflows is precise. As against this the computation of accounting is not exact.

ii) Quality and Quantity and Benefit and Time Value of Money:

The second feature of wealth maximization criterion is that. It considers both the quality and quantity dimensions of benefits. Moreover, it also incorporates the time value of money. As stated earlier the quality of benefits refers to certainty with which benefits are received In future.

The more certain the expected cash in flows the better the quality of benefits and higher the value. On the contrary the less certain the flows the lower the quality and hence, value of benefits. It should also be noted that money has time value. It should also be noted that benefits received in earlier years should be valued highly than benefits received later.

The operational implication of the uncertainty and timing dimensions of the benefits associated with a financial decision is that adjustments need to be made in the cash flow pattern. It should be made to incorporate risk and to make an allowance for differences in the timing of benefits. Net present value maximization is superior to the profit maximization as an operational objective.

It involves a comparison of value of cost. The action that has a discounted value reflecting both time and risk that exceeds cost is said to create value. Such actions are to be undertaken. Contrary to this actions with less value than cost, reduce wealth should be rejected. It is for these reasons that the Net Present Value Maximization is superior to the profit maximization as an operational objective.

PROFIT MAXIMIZATION VS WEALTH MAXIMIZATION

PROFIT MAXIMISATION - It is one of the basic objectives of financial management. Profit maximization aims at improving profitability, maintaining the stability and reducing losses and inefficiencies.
Profit in this context can be seen in 2 senses.

1. Profit maximization for the owner.

2. Profit maximization is for others.

Normally profit is linked with efficiency and so it is the test of efficiency.
However this concept has certain limitations like ambiguity i.e. the term is not clear as it is nowhere defined, it changes from person to person.
2. Quality of profit - normally profit is counted in terms of rupees. Normally amt earned is called as profit but it ignores certain basic ideas like wastage, efficiency, employee skill, employee's turnover, product mix, manufacturing process, administrative setup.
3. Timing of benefit / time value of profit - in inflationary conditions the value of profit will decrease and hence the profits may not be comparable over a longer period span.
4. Some economists argue that profit maximization is sometimes leads to unhealthy trends and is harmful to the society and may result into exploitation, unhealthy competition and taking undue advantage of the position.

WEALTH MAXIMISATION - One of the traditional

approaches of financial management , by wealth maximization we mean the accumulation and creation of wealth , property and assets over a period of time thus if profit maximization is aimed after taking care , of its limitations it will lead to wealth maximization in real sense, it is a long term concept based on the cash flows rather than profits an hence there can be a situation where a business makes losses every year but there are cash profits because of heavy depreciation which indirectly suggests heavy investment in fixed assets and that is the real wealth and it takes into account the time value of money and so is universally accepted.

IMPORTANT FUNCTIONS OF THE FINANCIAL MANAGER:

The important function of the financial manager in a modern business consists of the following:

1. Provision of capital: To establish and execute programmes for the provision of capital required by the business.
2. Investor relations: to establish and maintain an adequate market for the company securities and to maintain adequate liaison with investment bankers, financial analysis and share holders.
3. Short term financing: To maintain adequate sources for company's current borrowing from commercial banks and other lending institutions.
4. Banking and Custody: To maintain banking arrangement, to receive, has custody of accounts.
5. Credit and collections: to direct the granting of credit and the collection of accounts due to the company including the supervision of required arrangements for financing sales such as time payment and leasing plans.
6. Investments: to achieve the company's funds as required and to establish and co-ordinate policies for investment in pension and other similar trusts.
7. Insurance: to provide insurance coverage as required.
8. Planning for control: To establish, co-ordinate and administer an adequate plan for the control of operations.
9. Reporting and interpreting: To compare information with operating plans and standards and to report and interpret the results of operations to all levels of management and to the owners of the business.
10. Evaluating and consulting: To consult with all the segments of management responsible for policy or action concerning any phase of the operation of the business as it relates to the attainment of objectives and the effectiveness of policies, organization structure and procedures.
11. Tax administration: to establish and administer tax policies and procedures.
12. Government reporting: To supervise or co-ordinate the preparation of reports to government agencies.
13. Protection of assets: To ensure protection of assets for the business through internal control, internal auditing and proper insurance coverage.

DEBENTURES

The issue of debentures by public limited companies is regulated by Companies Act 1956. Debenture is a document, which either creates a debt or acknowledges it. Debentures are issued through a prospectus. A debenture is issued by a company and is usually in the form of a certificate, which is an acknowledgement of indebtedness. They are issued under the company's seal. Debentures are one of a series issued to a number of lenders.

The date of repayment is invariably specified in the debenture. Generally debentures are issued against a charge on the assets of the company. Debentures may, however, be issued without any such charge. Debenture holders have no right to vote in the meetings of the company.

Kinds of Debentures

1. Bearer Debentures: They are registered and are payable to its bearer .They are negotiable instruments and are transferable by delivery.

2. Registered Debentures: They are payable to the registered holder whose name appears both on debenture and in the register of debenture holders maintained by the company. Registered debentures can be transferred but have to be registered again. Registered debentures are not negotiable instruments. PI registered debenture contains a commitment to pay the principal sum and interest. It also has a description of the charge and a statement that it is issued subject to the conditions endorsed therein.

3. Secured Debentures: Debentures which create a charge on the assets of the company, which may be fixed or floating, are known as secured debentures.

4. Unsecured or Naked Debentures: Debentures, which are issued without any charge on assets, are unsecured or naked debentures, The holders are like unsecured creditors and may sue the company for recovery of debt.

5. Redeemable Debentures: Normally debentures are issued on the condition that they shall be redeemed after a certain period. They can, however, be reissued after redemption under Section 121 of Companies Act 1956.

6. Perpetual Debentures: When debentures are irredeemable they are called Perpetual.

7. Convertible Debentures: If an option is given to convert debentures into equity shares at stated rate of exchange after a specified period they are called convertible debentures. In our country the convertible debentures are very popular. On conversion, the holders cease to be lenders and become owners. Debentures are usually issued in a series with a *pari passu* (at the same rate) clause which entitles them to be discharged rate ably though issued at different times. New series of debentures cannot rank *pari passu* with old series unless the old series provides so.

8. New debt instruments issued by public limited companies are participating debentures, convertible debentures with options, third party convertible debentures, and convertible debentures redeemable at premium, debt equity swaps and zero coupon convertible notes.

9. Participating Debentures: They are unsecured corporate debt securities, which participate in the profits of the company. They might find investors if issued by existing dividend paying companies.

10. Convertible Debentures with Options: They are a derivative of convertible debentures with an embedded option, providing flexibility to the issuer as well as the investor to exit from the terms of the issue. The coupon rate is specified at the time of issue.

11. Third Party convertible Debentures: They are debt with a warrant allowing the investor to subscribe to the equity of a third firm at a preferential vis-à-vis the market price. Interest rate on third party convertible debentures is lower than pure debt on account of the conversion option.

12. Convertible Debentures Redeemable at a premium: Convertible debentures are issued at face value with an option entitling investors to later sell the bond to the issuer at a premium. They are basically similar to convertible debentures but embody less risk.

BALANCE SHEET

The balance sheet is a significant financial statement of the firm. In fact, it is called the fundamental accounting report. Other terms to describe this financial statement are the statement of financial position or the position statement. As the name suggests, the balance sheet provides information about the financial standing / position of a firm at a particular point of time, say as on March 31. It can be visualized as a snap shot of the financial status of a company. The position of the firm on the preceding or the following day is bound to be different.

The financial position of a firm as disclosed by the balance sheet refers to its resources and obligations, and the interest of its owners in the business. In operational terms, the balance sheet contains information regarding the assets, liabilities and shareholder's equity. The balance sheet can be present in either of the two forms: Report form or Account form.

Contents of the balance sheets:

1) Assets
2)
3) Liabilities

Assets:

Assets may be described as valuable resources owned by a business which have been acquired at a measurable money cost. As an economics resource, they satisfy three requirements. In the first place, the resource must be valuable. A resource is valuable if it is in cash or convertible into cash or it can provide future benefits to the operations of the firm. Secondly, the resources must be owned in the legal sense of the term.

Finally, the resource must be acquired at a measurable money cost. In case where an asset is not acquired with cash or promise to pay cash, the criterion is, what the asset would have cost, had cash been paid for it.

The assets in the balance sheet are listed either in the order of liquidity-promptness with which they are expected to be converted into cash- or in reverse order, that is, fixity or listing of the least liquid asset first, followed by others. All assets are grouped into categories, that is, assets with similar characteristics are put into one category. The assets included in one category are different from those in other categories. The standard classification of assets divides them into:

1) Fixed assets/ long term assets
2) Current assets
3) Investments
4) Other assets

Liabilities:

The second major content of the balance sheet is liabilities of the firm. Liabilities may be defined as the claims of outsiders against the firm. Alternatively, they represent the amount that the firm owes to outsiders that is, other than owners. The assets have to be financed by different sources.

One source of funds is borrowing- long term as well as short term. The firms can borrow on a long term basis from financial institutions/ banks or through bonds/ mortgages/ debentures.

The short term borrowing may be in the form of purchase of goods and services on credit. These outside sources from which a firm can borrow are termed as liabilities. Since they finance the assets, they are, in a sense, claims against the assets. The amount shown against the liability items is on the basis of the amount owed, not the amount payable.
Depending upon the periodicity of the funds, liabilities can be classified into

1) Long-term liabilities

   Current liabilities

FORMS OF PRESENTATION OF FINANCIAL STATEMENTS

THERE ARE 2 FORMS OF PRESENTATION OF FINANCIAL STATEMENTS:

- TRADITIONAL T-FORM
- MODERN VERTICAL FORM

GIVEN BELOW ARE THE TRADITIONAL FORMS OF TRADING AND PROFIT & LOSS ACCOUNT AND THE BALANCE SHEET

TRADING AND PROFIT & LOSS ACCOUNT

TO PURCHASES	BY SALES
TO OPENING STOCK	
	BY CLOSING STOCK
TO WAGES	
TO CARRIAGE	
TO GROSS PROFIT	
TO ADMINISTRATIVE EXPENSES	BY GROSS PROFIT
TO SELLING EXPS.	
TO FINANCIAL EXPS.	
TO NET PROFIT	

BALANCE SHEET AS ON

LIABILITIES	ASSETS
SHARE CAPITAL	FIXED ASSETS
RESERVES & SURPLUS	INVESTMENTS
SECURED LOANS & UNSECURED LOANS ADVANCES	URRENT ASSETS/ LOANS/
CURRENT LIABILITIES & PROVISIONS	MISC. EXPENDITURE TO THE EXTENT NOT WRITTEN OFF

GIVEN BELOW ARE THE MODERN FORMS OF TRADING AND PROFIT & LOSS ACCOUNT AND THE BALANCE SHEET

VERTICAL REVENUE STATEMENT

I. NET SALES
II COST OF GOODS SOLD
OPENING STOCK
+ PURCHASES
+ WAGES
- CLOSING STOCK
III. GROSS PROFIT
IV. ADD: OPERATING INCOME
V. LESS: OPERATING EXPENSES
VI. OPERATING NET PROFIT
VII. ADD: NON-OPERATING INCOME
VIII. LESS: NON-OPERATING EXPENSES
IX. NET PROFIT BEFORE INTEREST AND TAX
X. LESS: TAX
XI. NET PROFIT AFTER TAX

VERTICAL BALANCE SHEET

I. **sources of funds**

1. SHAREHOLDERS FUNDS EQUITY CAPITAL PREFERENCE SHARE CAPITAL
ADD: RESERVES & SURPLUS GENERAL RESERVE
P/L A/C LESS: FICTITIOUS ASSETS PRELIMINARY ASSETS 2. BORROWED FUNDS SECURED LOANS UNSECURED LOANS XXXXX II. **Application of funds** FIXED ASSETS INVESTMENTS WORKING CAPITAL CURRENT ASSETS LESS: CURRENT LIABILITIES

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RATIO ANALYSIS

Ratio analysis is the method or process by which the relationship of items or groups of items in the financial statements are computed, determined and presented. Ratio analysis is an attempt to derive quantitative measures or guides concerning the financial health and profitability of the business enterprise. Ratio analysis can be used both in trend and static analysis. There are several ratios at the disposal of the analyst but the group of ratios he would prefer depends on the purpose and the objectives of the analysis.

Accounting ratios are effective tools of analysis. They are indicators of managerial and overall operational efficiency. Ratios, when properly used are capable of providing useful information. Ratio analysis is defined as the systematic use of ratios to interpret the financial statements so that the strengths and weaknesses of a firm as well as its historical performance and current financial condition can be determined the term ratio refers to the numerical or quantitative relationship between items/ variables. This relationship can be expressed as:

1) Fraction
2) Percentages
3) Proportion of numbers

These alternative methods of expressing items which are related to each other are, for purposes of financial analysis, referred to as ratio analysis. It should be noted that computing the ratio does not add any information in the figures of profit or sales. What the ratios do is that they reveal the relationship in a more meaningful way so as to enable us to draw conclusions from them.

ADVANTAGES OF RATIO ANALYSIS

- Ratios simplify and summarize numerous accounting data in a systematic manner so that the simplified data can be used effectively for analytical studies.
- Ratios avoid distortions that may result the study of absolute data or figures
- Ratios analyze the financial health, operating efficiency and future prospects by inter-relating the various financial data found in the financial statement.
- Ratios are invaluable guides to management. They assist the management to discharge their functions of planning, forecasting, etc. efficiently.
- Ratios study the past and relate the findings to the present. Thus useful inferences are drawn which are used to project the future.
- Ratios are increasingly used in trend analysis.

- Ratios being measures of efficiency can be used to control efficiency and profitability of a business entity.
- Ratio analysis makes inter-firm comparisons possible. i.e. evaluation of interdepartmental performances.
- Ratios are yard stick increasingly used by bankers and financial institutions in evaluating the credit standing of their borrowers and customers.

LIMITATIONS OF RATIO ANALYSIS:

An investor should caution that ratio analysis has its own limitations. Ratios should be used with extreme care and judgment as they suffer from certain serious drawbacks. Some of them are listed below:

1. Rations can sometimes be misleading if an analyst does not know the reliability and soundness of the figures from which they are computed and the financial position of the business at other times of the year. A business enterprise for example may have an acceptable current ratio of 3:1 but a larger part of accounts receivables comprising a great portion of the current assets may be uncollectible and of no value. When these are deducted the ratio might be 2:1

2. It is difficult to decide on the proper basis for comparison. Ratios of companies have meaning only when they are compared with some standards. Normally, it is suggested that ratios should be compared with industry averages. In India, for example, no systematic and comprehensive industry ratios are complied.

3. The comparison is rendered difficult because of differences in situations of 2 companies are never the same. Similarly the factors influencing the performance of a company in one year may change in another year. Thus, the comparison of the ratios of two companies becomes difficult and meaningless when they are operation in different situations.

4. Changes in the price level make the interpretations of the ratios Invalid. The interpretation and comparison of ratios are also rendered invalid by the changing value of money. The accounting figures presented in the financial statements are expressed in monetary unit which is assumed to remain constant. In fact, prices change over years and as a result. Assets acquired at different dates will be expressed at different values in the balance sheet. This makes comparison meaningless.

For e.g. two firms may be similar in every respect except the age of the plant and machinery. If one firm purchased its plant and machinery at a time when prices were very low and the other purchased when prices were high, the equal rates of return on investment of the two firms cannot be interpreted to mean that the firms are equally profitable. The return of the first firm is overstated because its plant and machinery have a low book value.

5. The differences in the definitions of items, accounting, policies in the balance sheet and the income statement make the interpretation of ratios difficult. In practice difference exists as to the meanings and accounting policies with reference to stock valuation, depreciation, operation profit, current assets etc. Should intangible assets be excluded to calculate the rate of return on investment? If intangible assets have to be included, how will they be valued? Similarly, profit means different things to different people.

6. Ratios are not reliable in some cases as they many be influenced by window / dressing in the balance sheet.

7. The ratios calculated at a point of time are less informative and defective as they suffer from short-term changes. The trend analysis is static to an extent. The balance sheet prepared at different points of time is static in nature. They do not reveal the changes which have taken place between dates of two balance sheets. The statements of changes in financial position reveal this information, bur these statements are not available to outside analysts.

8. The ratios are generally calculated from past financial statements and thus are no indicator of future. The basis to calculate ratios are historical financial statements. The financial analyst is more interested in what happens in future.

While the ratios indicate what happened in the past Art outside analyst has to rely on the past ratios which may not necessarily reflect the firm's financial position and performance in future.

<u>FUND FLOW STATEMENT</u>

Fund flow statement also referred to as statement of "source and application of funds" provides insight into the movement of funds and helps to understand the changes in the structure of assets, liabilities and equity capital. The information required for the preparation of funds flow statement is drawn from the basic financial statements such as the Balance Sheet and Profit and loss account. "Funds Flow Statement" can be prepared on total resource basis, working capital basis and cash basis. The most commonly accepted form of fund flow is the one prepared on working capital basis.

CASH FLOW VS FUND FLOW

CASH FLOW - A Cash Flow Statement is a statement which shows inflows and outflows of cash and cash equivalents of an enterprise during a particular period. It provides information about cash flows, associated with the period's operations and also about the entity's investing and financing activities during the period.

FUND FLOW – Fund Flow Statement also referred to as the statement of "Source and Application of Funds" provides insight into the movement of funds and helps to understand the changes in the structure of assets, liabilities and equity capital.,

A fund flow statement is different from cash flow statement in the following ways –

i). Funds flow statement is based on the concept of working capital while cash flow statement is based on cash which is only one of the element of working capital. Thus cash flow statement provides the details of funds movements.

ii). Funds flow statement tallies the funds generated from various sources with various uses to which they are put. Cash flow statement records inflows or outflows of cash, the difference of total inflows and outflows is the net increase or decrease in cash and cash equivalents.

iii). Funds Flow statement does not contain any opening and closing balance whereas in cash flow statement opening as well as closing balances of cash and cash equivalents are given.

iv). Funds Flow statement is more relevant in estimating the firm's ability to meet its long-term liabilities, however, cash flow statement is more relevant in estimating the firms short-term phenomena affecting the liquidity of the business.

v). The Cash Flow statement considers only the actual movement of cash whereas the funds flow statement considers the movement of funds on accrual basis.

vi). In cash flow statement cash from the operations are calculated after adjusting the increases and decreases in current assets and liabilities. In funds flow statement such changes in current items are adjusted in the changes of working capital.

vii). Cash flow statement is generally used as a tool of financial analysis which is utilized by the management for short- term financial analysis and cash planning purposes, whereas funds flow statement is useful in planning intermediate and long-term financing.

What are the Advantages of Fund Flow Statements?

Advantages of fund flow are as follows:

- management of various companies are able to review their cash budget with the aid of fund flow statements
- Helps in the evaluation of alternative finance and investments plan
- Investors are able to measure as to how the company has utilized the funds supplied by them and its financial strengths with the aid of funds statements.
- It serves as an effective tool to the management of economic analysis
- It explains the relationship between the changes in the working capital and net profits.
- Help in the planning process of a company
- It is an effective tool in the allocation of resources
- Helps provide explicit answers to the questions regarding liquid and solvency position of the company, distribution of dividend and whether the working capital is effectively used or not.
- Helps the management of companies to forecast in advance the requirements of additional capital and plan its capital issue accordingly.
- Helps in determining how the profits of a company have been invested: whether invested in fixed assets or in inventories or ploughed back.

WHAT IS WEIGHTED AVERAGE COST OF CAPITAL?

The term cost of capital means the overall composite cost of capital defined as "weighted average of the cost of each specific type of fund. The use of weighted average and not the simple average is warranted by the fact that proportions of various sources of funds in the capital structure of a firm are different.

Therefore the overall cost of capital should take into account the weighted average. The weighted cost of capital based on historical weights takes into account a long-term view.

The term cost of capital, as the acceptance criterion or investment proposals, is used in the sense of the combined cot of all sources of financing. This is mainly because focus is on the valuation of the firm as a whole. It is related to the firm's objective of wealth maximization.

Thus, the weighted average cost of funds of a company is based on the mix of equity and loan capital and their respective costs. A distinction is usually drawn between the average cost of all funds in an existing balance sheet and the marginal cost of raising new funds.

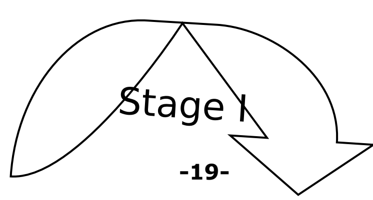
WHAT IS OPERATING CYCLE FOR WORKING CAPITAL?

The operating cycle is the length of time between the company's outlay on raw materials, wages and other expenditures and the inflow of cash from the sale of the goods. In a manufacturing business, operating cycle is the average time that raw materials remain in stock less the period of credit taken from suppliers, plus the time taken for producing the goods, plus the time goods remain in finished inventory, plus the time taken by customers to pay for the goods.

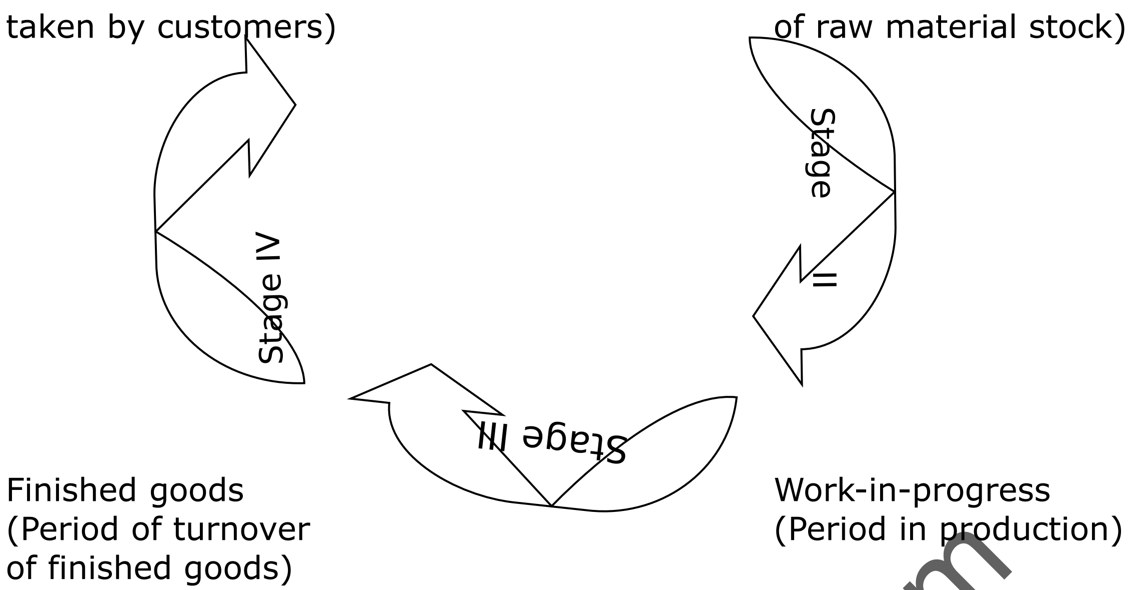
Operating cycle concept is important for management of cash and management of working capital because the longer the operating cycle the more financial resources the company needs. Therefore, the management has to remain cautious that the operating cycle should not become too long.

The stages of operating cycle could be depicted through the figure given:
CASH (Ultimate Stage).

Sundry Debtors
(Period of credit



Raw materials
(Period of Turnover



The above figure would reveal that operating cycle is the time that elapses between the cash outlay and the cash realization by the sale of finished goods and realization of sundry debtors. Thus cash used in productive activity, often some times comes back from the operating cycle of the activity. The length of operating cycle of an enterprise is the sum of these four individual stages i.e. components of time.

<u>WHAT IS PREFERENCE SHARE CAPITAL?</u>

Preference capital represents a hybrid form of financing – it takes some characteristics of equity and some attributes of debentures.

It resembles equity in the following ways:

(i) Preference dividend is payable only out of distributed profits

(ii) Preference dividend is not an obligatory payment (the payment of preference dividend is entirely within the discretion of the directors)

Preference capital is similar to debentures in several ways:

(i) The dividend rate of preference capital is usually fixed

(ii) The claim of preference shareholders is prior to the claim of equity shareholders

(iii) Preference shareholders do not normally enjoy the right to vote

ADVANTAGE AND DISADVANTAGE OF PREFERENCE CAPITAL

Preference Capital has the following Advantages:

1) There is no legal obligation to pay preference dividend. A company does not face bankruptcy or legal action if it skips preference dividend.

2) There is no redemption liability in the case of perpetual preference shares. Even in the case of redeemable preference shares, financial distress may not be much because:

   (i) Periodic sinking fund payments are not required
   (ii) Redemption can be delayed without significant penalties

3) Preference capital is generally regarded as part of net worth. Hence, it enhances the creditworthiness of the firm.

4) Preference shares do not, under normal circumstances, carry voting right. Hence, there is no dilution of control.

Preference Capital, however suffers from some serious shortcomings:

1) Compared to debt capital, it is an expensive source of financing because the dividend paid to preference shareholders is not, unlike debt interest, a tax-deductible expense.

2) Though there is no legal obligation to pay preference dividends, skipping them can adversely affect the image of the firm in the capital market.

3) Compared to equity shareholders, preference shareholders have a prior claim on the assets and earnings of the firm.

WHAT IS TREND ANALYSIS?

Trend analysis is employed when it is required to analyze the trend of data shown in a series of financial statements of several successive years. The trend obtained by such an analysis is expressed as percentages. Trend percentage analysis moves in one direction either upward or downward progression or regression. This method involves the calculation of percentage relationship that each statement bears to the same item in the base year. The base year may be any one of the periods involved in the analysis but the earliest period is mostly taken as the base year. The trend percentage statement is an "analytical device for condensing the absolute rupee data" by comparative statements.

Merits of Trend Analysis:

- Trend percentages indicate the increase or decrease in an accounted item along with the magnitude of change in percentage, which is more effective than the absolute data.
- The trend percentages facilitate an efficient comparative study of the financial performance of a business enterprise over a period of time.

Demerits of Trend Analysis:

- Any one trend by itself is not very analytical and informative.
- If interpretation has to be done on percentages and ratios in isolation and not along with the absolute data from which the percentages have been derived, the inferences tend to be absurd and baseless.
- Comparability of trend percentages is unfavorably affected when the accounts have not been drawn on a consistent basis year after year and when the price level is not constant.
- During inflationary periods the data over a period of time becomes incomparable unless the absolute rupeee data is adjusted.
- There is always the danger of selecting the base year which may not be representative, normal and typical.
- Though the trend percentages provide significant information, undue importance and emphasis should not be laid down on the percentages when there is a small number in the base year. In such cases even a slight variation will be magnified by the percentage change.

Uses

- It indicates the increase or decrease in an accounted item along with the magnitude of change in percentage, which is more effective than absolute data.
- The trend percentage facilitates an effective comparative study of the financial performance of a business enterprise over a period of time

WHAT IS COMMERCIAL PAPER?

A company can use commercial papers to raise funds. It is a promissory note carrying the undertaking to repay the amount on or after a particular date. Normally it is an unsecured means of borrowing and the companies are allowed to issue commercial papers as per the regulations issued by SEBI and Company's Act. Some of them are:

a) Minimum size 25 Lacs

b) Maximum limit is 100% of working capital limit.

c) Period is from 15 days to 1 year, and every renewal is treated as a fresh commercial paper.

d) While using Commercial Paper, company should ensure that its net worth is at least 4 crores or more and it has been noted by at least 2 rating agencies like CRISIL, ICRA, CARE.

e) Commercial papers on maturity are to be honoured at face value and the registrars or the issue agencies lay down all the formalities of funding through commercial papers.

CASH BUDGETING

1. Cash Budget shows the policy and programme of cash inflows and outflows to be followed in a future period under planned condition.
2. Cash Budget usually of 2 parts gives detailed estimate of cash receipts and cash distribution. Estimate of cash receipts budget on cash incoming. Estimate of cash distribution based on cash outgoing.
3. Cash Budget is a tool of control since it represents actions which can be shaped to will so that it can be suited in the conditioning which may or may not happen.
4. Cash Budget begins when Cash Forecasting ends. Cash Forecasting is convince in Cash Budget.
5. Cash Budget has a limited scope.
6. Cash Budget denotes a definite target.

CASH FORECASTING:

1. Cash Forecast is a main estimate of cash balance likely to happen under anticipated conditions using a specified period of time.

2. Cash Forecasting is an estimate showing amt of cash which would be available in future period.

3. Cash forecast being statement of future event does not connote any sense of control.

4. Cash Forecasting is a preliminary step for Cash Budgeting. It ends with the forecast of likely cash balances.

5. Cash Forecast is a wider scope.

6. Cash Forecasting denotes some degree of flexibility.

LEVERAGES

The employment of an asset or source of funds for which the firm has to pay a fixed cost or fixed return maybe termed as leverage.

OPERATING LEVERAGE – Operating Leverage may be defined as the firm's ability to use fixed operating costs to magnify the effects of changes in sales on its earnings before interest and taxes.

FINANCIAL LEVERAGE – Financial Leverage can be defined as the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on the earnings per share.

i). Operating Leverage results from the existence of fixed operating expenses in the firm's income stream whereas Financial Leverage results from the presence of fixed financial charges in the firm's income stream.

ii). Operating Leverage is determined by the relationship between a firm's sales revenues and its earnings before interest and taxes. (EBIT)Financial Leverage is determined by the relationship between a firm's earnings before interest and tax and after subtracting the interest component.

iii). Operating Leverage = $\frac{\text{Contribution}}{\text{EBIT}}$

Financial Leverage = $\frac{\text{EBIT}}{\text{EBT}}$

iv). Operational Leverage relates to the Assets side of the Balance Sheet, whereas Financial Leverage relates to the Liability side of the Balance Sheet.

v). Operational Leverage affects profit before interest and tax, whereas Financial Leverage affects profit after interest and tax.

vi). Operational Leverage involves operating risk of being unable to cover fixed operating cost, whereas Financial Leverage involves financial risk of being unable to cover fixed financial cost.

vii). Operational Leverage is concerned with investment decisions, whereas Financial Leverage is concerned with financing decisions.

viii). Operating Leverage is described as a first stage leverage, whereas Financial Leverage is described as a second stage leverage.

TOOLS USED FOR FINANCIAL ANALYSIS

The various tools used for financial analysis are:

- Fund flow Statement
- Ratio Analysis
- Common Size Statements
- Comparative Financial Statements
- Trend Analysis
- Cash Budget
- Working Capital
- Leverages

Fund Flow Statement

Fund flow statement also referred to as statement of "source and application of funds" provides insight into the movement of funds and helps to understand the changes in the structure of assets, liabilities and equity capital. The information required for the preparation of funds flow statement is drawn from the basic financial statements such as the Balance Sheet and Profit and loss account. "Funds Flow Statement" can be prepared on total resource basis, working capital basis and cash basis. The most commonly accepted form of fund flow is the one prepared on working capital basis.

Ratio Analysis

Ratio analysis is the method or process by which the relationship of items or groups of items in the financial statements are computed, determined and presented. Ratio analysis is an attempt to derive quantitative measures or guides concerning the financial health and profitability of the business enterprise. Ratio analysis can be used both in trend and static analysis. There are several ratios at the disposal of the analyst but the group of ratios he would prefer depends on the purpose and the objectives of the analysis.

Accounting ratios are effective tools of analysis. They are indicators of managerial and overall operational efficiency. Ratios, when properly used are capable of providing useful information. Ratio analysis is defined as the systematic use of ratios to interpret the financial statements so that the strengths and weaknesses of a firm as well as its historical performance and current financial condition can be determined the term ratio refers to the numerical or quantitative relationship between items/ variables. This relationship can be expressed as:

1. Fraction
2. Percentages
3. Proportion of numbers

These alternative methods of expressing items which are related to each other are, for purposes of financial analysis, referred to as ratio analysis. It should be noted that computing the ratio does not add any information in the figures of profit or sales. What the ratios do is that they reveal the relationship in a more meaningful way so as to enable us to draw conclusions from them.

Common Size Statements

It facilitates the comparison of two or more business entities with a common base. In case of balance sheet, Total assets or liabilities or capital can be taken as a common base. These statements are called "Common Measurement" or "Component Percentage" or "100 percent" statements. Since each statement is reduced to the total of 100 and each individual component of the statement is represented as a % of the total of 100 which invariably serves as the base.

Thus the statement prepared to bring out the ratio of each asset of liability to the total of the balance sheet and the ratio of each item of expense or revenues to net sales known as the Common Size statements.

Comparative Financial Statements

Comparative financial statements is statement of the financial position of a business so designed as to facilitate comparison of different accounting variables for drawing useful inferences.

Financial statements of two or more business enterprises may be compared over period of years. This is known as "inter-firm comparison"
Financial statements of particular business enterprise maybe compared over two periods of years. This is known as "inter-period comparison".

Trend Analysis

Trend analysis is employed when it is required to analyze the trend of data shown in a series of financial statements of several successive years. The trend obtained by such an analysis is expressed as percentages. Trend percentage analysis moves in one direction either upwards or downwards, progression or regression. This method involves the calculation of percentages relationship that each statement bears to the same item in the base year.

The base year maybe any one of the periods involved in the analysis but the earliest period id mostly taken as the base year. The trend percentage statement is an "analytical device for condensing the absolutely rupee data" by comparative statements.

Cash Budget

Cash budget is a forecast or expected cash receipts and payments for a future period. It consists of estimates of cash receipts, estimate of cash disbursements and cash balance over various time intervals. Seasonal factors must be taken into account while preparing cash budget. It is generally prepared for 1 year and then divided into monthly cash budgets.

Working Capital

Working capital is the amount of funds held in the business or incurring day to day expenses. It is also termed as short term funds held in the business. It is ascertained by finding out the differences between total current assets and total current liabilities. Working capital is a must for every organization. It is like a life blood in the body. It must be of sufficient amount and should be kept circulated in the different forms of current assets and current liabilities. The success of organization depends upon how successfully the circulation of short term fund is maintained smoothly and speedily. Working capital is also compared with the water flowing in the river as the water is always flowing it is pure water similarly working capital should be kept circulated in different short term assets.

Leverages

The employment of an asset or source of funds for which the first firm has to pay a fixed cost or fixed return may be termed as leverage.

Operating leverages: is determined by the relationship between firms, sales revenue and its earnings before interest and taxes (EBIT) which are generally called as Operating profits. Operating leverage results from the existence of fixed operating expenses in the firm's income stream. the operating leverage may be defined as the firm's ability to use fixed operating cost to magnify the affects of charges In sales on its earnings before interest and taxes.

Financial leverages: it relates to the financing activities of a firm. Financial leverage results from the presence of fixed financial charges in the firm's income stream. Financial leverages concerned with the effects or changes in the EBIT in the earnings available to equity shareholders. It is defined as the ability of a firm to use fixed financial charges to magnify the effects or changes in EBIT on the earnings per share.

SOURCES OF FINANCE

Sources of Short term and long term finance

The business requires two types of finance namely:

1. Short term finance
2. Long term finance

Short term finance is concerned with decisions relating to current assets and current liabilities and is also called as working capital finance.
Short term financial decisions typically involve cash flows within a year or within the operating cycle of the firm. Normally short term finance is for a period up to 3 years.

The main sources of short term finance are:

1. Cash credit
2. Short term loans from financial institutions
3. Bill Discounting
4. Letter of credit
5. Inter-corporate deposits
6. Commercial papers
7. Factoring
8. Working capital advance by commercial banks

1. Cash Credit:
Cash Credit facility is taken basically for financing the working capital requirements of the organization. Interest is charged the moment cash credit is credited to the Bank A/C irrespective of the usage of the Cash Credit.

2. Short term loans from financial institutions: Bank overdraft

3. Bill Discounting:
Bill Discounting is a short term source of finance, whereby Bills Receivable received from debtors is in cashed from the bank at a discounted rate.

4. 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.
A letter of credit is issued by a bank on behalf of its customer to the seller. As per this document, the bank agrees to honor drafts drawn on it for the supplies made to the customer. I f the seller fulfills the condition laid down in the letter of credit.

5.Inter- corporate Deposits
A deposit made by one company with another, normally for a period of six months is referred to as an ICD ie. Short-term deposits with other companies are a fairly attractive form of investment of short term funds in terms of rate of return.
These deposits are usually of three types:

a. Call deposits: A call deposit is withdraw able by the lender on a given days notice.
b. Three-months Deposits: These deposits are taken by the borrowers to tied over a short term cash inadequacy
c. Six-month Deposits: Normally lending companies do not extend deposits beyond this time frame. Such deposits are usually made with first-class borrowers.

6. Commercial papers
A company can use commercial papers to raise funds. It is a promissory note carrying the undertaking to repay the amount or/ on after a particular date.

7. Factoring
A factor is a financial institution which offers services relating to management and financing of debts arising form credit sales. Factoring provides resources to finance receivables as well as facilitates the collection of receivables.
There are 2 banks, sponsored organizations which provide such services:

a. SBI factors and commercial services LTD

b. Canbank factors LTD, started operations since the beginning of 1997.

8. Working capital advance by commercial banks

Since the above sources do not permit the use of funds, for a longer period of time, the business has to seek further sources, if the need is for a longer period of time, i.e. This extends up to 3 years and above.

When a firm wants to invest in long term assets, it must find the needs to finance them. The firm can rely to some extent on funds generated internally. However, in most cases internal resources are not enough to support investment plans. When that happens the firm may have to curtail investment plan or seek external funding. Most firms choose to take external funding. They supplement internal funding with external funding raise from a variety of sources.
The main sources of long term finance can broadly divided into:

Internal sources include:

a. Share capital (Equity shares and preference shares)
b. Reserves and Surplus
c. Personal loans and advances from owners called as 'Quasi Capital'

External sources include:

a. Term loan from banks, financial institutions and international bodies like International Monetary Funds, World Bank, Asian Development Bank.
b. Debentures
c. Loans and advances from friends and relatives
d. Inter- Corporate Deposits
e. Asian Depository Receipts / Global Depository Receipts
f. Commercial Papers.

The short term or long term finance is a function of financial management. The good and efficient management is that which can raise the funds whenever required and at the most competitive terms and conditions. Raising of funds either internally or externally requires a professional approach and also complying with so many legal, technical and statutory requirements prescribed by the Companies Act, Securities Exchange Board Of India, Stock Exchanges Authorities and also allied laws like Income Tax, Foreign Exchange Management Act, Banking Regulations Act, etc.

CONTENTS OF THE CAPITAL STRUCTURE

The capital structure includes Funds received from the owners of the business i.e. the Shareholders and therefore called as:

- Share holders fund
- Proprietor fund
- Owners fund

The share holders fund are further classified into

- Share Capital: Equity and Preference
- Reserves and Surplus: General reserve, etc
- Fictitious assets: Preliminary expenses etc

The capital structure also includes Borrowed Funds which are further divided into:

- Secured Loans (Bank loans, debentures, etc)
- Unsecured loans (loans from friends and relatives)

The Result of which is: The Capital employed i.e. the total long term funds supplied by the creditors and owners of the firm. It can be computed in 2 ways. First as mentioned above – the non-current liabilities plus owner's equity. Alternatively its is equal to net working capital plus fixed assets.

Kd(before tax) = R

Kd (After tax) = R (1-t)

$$Ke = \frac{\text{Dividend}}{\text{Net proceeds}} * 100$$

The format of the capital structure will further illustrate the meaning.

(Refer to choudhari and chopde book for the format)

Trading on Equity

Trading on Equity refers to the practice of using borrowed funds, carrying a fixed charge, to obtain a higher return to the Equity Shareholders.
With a larger proportion of the debt in the financial structure, the earnings, available to the owners would increase more than the proportionately with an increase in the operating profits of the firm.

This is because the debt carries a fixed rate of return and if the firm is able to earn, on the borrowed funds, a rate higher than the fixed charges on loans, the benefit will go the shareholders. This is referred to as "Trading on Equity"

The concept of trading on equity is the financial process of using debt to produce gain for the residual owners or the equity shareholders. The term owes its name also to the fact that the equity supplied by the owners, when the amount of borrowing is relatively large in relation to capital stock, a company is said to be trading on equity, but where borrowing is comparatively small in relation to capital stock, the company is said to be trading on thick equity. Capital gearing ration can be used to judge as to whether the company is trading on thin or thick equity.

Illustration

PARTICULARS	A	B	C	A	B	C
EQUITY	200	200	200	800	600	200
DEBT@15%	800	800	800	200	400	800
TOTAL	1000	1000	1000	1000	1000	1000
EBIT	300	400	200	300	300	300
LESS:INTERSET@15%	120	120	120	30	60	120
NPBT	180	280	80	270	240	180
LESS:TAX@35%	63	98	28	94.50	84	63
NPAT	117	182	52	175.50	156	117
RETURN ON EQUTIY	58.50	91	26	21.94	26	58.50
%INC/DEC IN EBIT	-	33.33	(33.33)			
%INC/DEC IN ROE	-	55.56	(55.56)			

RECEIVABLES MANAGEMENT

The management of accounts receivables management deals with viable credit and collection policies. A very liberal credit policy will increase sales and also bad debt losses. On the other hand a conservative credit policy will reduce bad debt losses but also reduce sales. A good credit policy should seek to strike a reasonable balance between sales and bad debt losses.

The objective of receivables management is to promote sales and profits until that point is reached where the returns that the firm gels from funding of receivables is less than the cost that the firm has to incur in order to fund these receivables. This, the purpose of receivables is directly connected with the firms objective of making credit sales.

The following aspects of receivables management are important:

(A) Credit Policy: Credit policy means the decisions with regard to the credit standards, i.e. who gets credit and up to what amount and on what specific terms. The firms credit policy influences the sales level, the investment .level, in cash, inventories, accounts receivables and physical equipments, bad debt losses and collection costs. The various factors associated with credit policy are:

(i) Credit Standards

(ii) Credit Period

(iii) Cash Discount

(iv) Collection Programme.

Credit Standard means classification of customers to whom credit can not be expended or can be extended. A firm can take the help of credit rating agencies for this purpose.

Credit Period means the length of time customers are allowed to pay for their purchases. It may vary from 15 days to 60 days.

Cash Discount is generally offered to induce prompt payment by the customers, credit terms provide the percentage of discount and the period during which it may be available, for example, credit terms of 2/10 net 30 means that a discount of 2 percent is offered if the payment is made by the 10th day otherwise the full payment is due by the 30th day.

The Collection Programme means the collection effort of a firm as decided by the credit policy. The objective of the collection policy is to collect the receivables in time. The collection programme consists of the following details:

(1) Monitoring the state of receivables,

(2) Dispatch the letters to customers, whose due date is approaching,

(3) communicate the customers by telephone at about the due date,

(4) Threat of legal action to overdue accounts,

(5) Actual legal action against overdue accounts.

(B) Credit Evaluation: Credit evaluation means a review of a prospective customer by obtaining the information to judge the customers willingness and ability to pay his debt. In judging the credit worthiness of an applicant the three basic factors which should be considered are, character, capacity and collateral. The character refers to the willingness of the customer to honour his obligations. The capacity ' refers to the ability of a customers to pay on time and the collateral represents the security offered by him in the form of mortgages. A firm can use different ways to judge the creditworthiness of an applicant. Some of the ways are as follows:

- Analysis of financial statements
- obtaining of bank certificate
- Analysis of past experience
- Numerical credit scoring.

(C) Credit Granting Decision: Credit evaluation helps to judge the credit worthiness of a prospective customer. Credit granting decision is a procedure of final decision whether to grant credit to the prospective customer or not. The decision to grant credit or not depends upon the (cost benefit analysis. The manager can form a subjective opinion based on credit evaluation about the chance of getting payment and the chance of not getting payment. The relative chances of getting the payment or not getting the payment are at the back of his mind while taking such a decision.

CONCEPTUALS QUESTIONS:

Net worth: Net worth means total equity including reserves and surplus less intangible assets like goodwill.

(FA+CA) – (CL & Borrowed funds).

Capital employed: Capital employed is total shareholders fund and borrowed fund. In other words, it means total sources. The formula for capital employed is:

Capital employed=Share capital + reserves & surplus + P&L a/c (cr) + loans (borrowed funds).

Return on capital employed: Return on capital employed is the return on total resources or profitability on the overall investment viz total resources utilized by the business. Total resources employed or total capital employed means the total funds at the disposal of the business.

Common size statement: The determination of trends and comparisons of amounts are facilitated by use of percentage of figures instead of rupee amount. The amounts and accounts in financial statements are reduced to % and these % are presented for comparison purpose. Such statements are called common size statements.

Ratio analysis: Ratio analysis is the process of computing, determining and presenting the relationships between items or group of items in the financial statements through accounting ratios. An analysis is normally undertaken for the purpose of projecting financial position or profitability, knowledge of trends is usually more significant than knowledge of present status only. An analysis of trends through ratio analysis helps in appraisal of financial conditions, efficiency and profitability of a business. Ratio analysis helps to relate information in the financial data in a meaningful manner. It facilitates comparison.

Q) The following financial results indicate a mismatch between sales and profit, an increase in sales is followed by decrease in profit or vice versa. Discuss various possible results.

Ans) An increase in sales is followed by a decrease in profit or vice versa. It indicates that although sales might have increased, the cost of sales has increased much more that is why the profits have decreased. It could be possible that the operating expenses, administrative expenses and other expenses might have increased at a higher rate than the increase in sales so, the profit will definitely decrease. Another reason could be an increase in the cost of production which decreases the profit. It can be also that the sales might decrease and the profit increase. This may be decrease in operating cost or decrease in the cost of raw materials.

Q) State any 3 reasons for the changes in:
1) Expense ratio.
2) Current ratio.

A) a) Expense ratio is a profitability ratio, related to sales which can be computed by dividing expenses by sales.

Here the term expenses includes:-
i) Cost of goods sold
ii) Administrative expenses
iii) Selling and distribution expenses
iv) Financial expenses

The expenses ratio is closely profit margin, gross as well as net. It is very important for analyzing the profitability of a firm. A low expenses ratio is favourable whereas a high expenses ratio is unfavourable. The implications of a high expenses ratio is that only a relatively small percentage share of sales is available for meeting financial liabilities like interest, tax & dividends and so on.

Thus, an increase in a company's expenses ratio would leave the company in a financial crunch.

An analysis of the factors responsible for a low ratio may reveal changes in the selling price on the operating expenses. It is likely that individual items may behave differently.

While some operating expenses may show a rising trend, others may record a fall. The specific expenses ratio for each of the item of operating may be calculated. These ratios would identify the specific cause.

To, illustrate, an increase in selling expenses may be due to a number of reasons like:
i) General rise in selling expenses.
ii) Inefficiency of the Marketing department leading to uncontrolled promotional and other expenses.
iii) Growing competition.
iv) Ineffective advertising.
v) Inefficient utilization of resources.

b) Current ratio:

The current ratio is the ratio of total current assets to total current liabilities. The calculation is done by using the formula:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The current assets are those can be converted into cash within a short period of time during the ordinary course of business of a firm, whereas the current liabilities include liabilities which are short term obligations to be met within a year. Thus any change in the composition of current assets &/or liabilities will lead to a change in the current ratio.

The current ratio of a firm its short term solvency i.e. the ability to meet short term obligations. The higher the larger is the amount of rupees available per rupee of current liability, the more is the firm's ability to meet current obligations & assures greater safety of funds of short term creditors.

The flow of funds through current assets and liabilities account is quite inevitably uneven. Current assets might shrink due to reasons like: - i) bad debts, ii) inventories becoming obsolete or unsaleable, iii) occurrence of unexpected losses in marketable securities etc.

A firm should have a satisfactory and a reasonable current ratio [2:1 is considered to be satisfactory]. A satisfactory ratio depends upon the development of the capital market & the availability of long term funds to finance current assets, the nature of industry and so on. Thus the current ratio varies with variations in such factors.

The nature of the industry is one of the major cases for difference in the current ratio. For instance, public utility companies generally have a very little need for current assets. The wholesale dealers, on the other hand, purchasing goods on a cash/credit basis for a very short period but selling to retailers on credit basis, require a higher current ratio.

Q) As a creditor or investor or finance manager suggest any 3 ratios to be used for analysis with reasons.

Ans) Ratio analysis is a tool of financial analysis used to interpret the financial statements so that the strengths & weaknesses of a firm as well as its historical performance & current financial condition can be determined. Ratios are used for comparison with related facts. Comparison involves i) trends ratio, comparison of ratios of a firm over time. ii) inter-firm comparison, iii) comparison of items within a single year's financial statement of a firm & iv) comparison with standards or plans.

Ratios e classified into 4 broad groups:-

i) Liquidity ratio
ii) Capital structure/leverage ratio
iii) Profitability ratios &
iv) Activity ratios.

The use of following ratios is suggested:-

Firstly, the liquidity ratio as adequate liquidity is quite important since it indicates the firm's ability to meet current/short term obligations. Creditors are interested in the short term solvency of a firm.

Current ratio is one important component/type or liquidity ratio. It measures firm's short term solvency i.e. its ability to meet short term obligations by comparing the current assets and current liabilities. The higher the current ratio, the larger the amount of rupees available per rupee of current liability, the more is the firm's ability to meet current obligations & assures greater safety of funds of short term creditors.

Secondly the leverage/capital structure ratio. These ratios throw light on the long term solvency of a firm. It judges the soundness of a firm in terms of its ability to pay the interests regularly to long term creditors & repayment of principal on maturity.

Among the leverage ratios, the debt-equity is one of the important ones. It shows the relationships between borrowed bunds and owner's capital to measure the long term financial solvency of the firm. This ratio reflects the relative claims of the creditors & shareholders against the assets of the firm. Alternatively, it includes the relative proportions of debt & equity in financing the assets of the firm. It can be expressed as follows:

$$\text{Debt-Equity ratio} = \frac{\text{Long term debt}}{\text{Shareholder's equity}}$$

Or

$$\frac{\text{Total debt}}{\text{Shareholder's equity}}.$$

The D/E ratio is thus, the ratio of the amount invested by outsiders to the amount invested by the owners of the business.

It is an important tool of financial analysis to appraise the financial structure of a firm. It has important implications from the view point of creditors, owners & the firm itself.

A high ratio shows a large share of financing by the creditors of the firm while a lower ratio implies smaller claim by creditors. It indicates the margin of safety to creditors.

For ex: If the D/E ratio is 2:1, it implies for every rupee of outside liability, the firm has two rupees of the owner's capital. Hence there is a safety of margin of 66.67% available to the creditors of the firm. Conversely if the D/E ratio is 1:2, it implies low safety of margin for the creditors.

A high D/E ratio has equally serious implications from the firm's point of view. It would affect the flexibility of operations of the firm, restrict the borrowings etc. the shareholders would however gain in 2 ways:-

i) with a limited stake they would be able to retain control of the firm.
ii) The returns would be magnified.
A low D/E ratio would have just the opposite implications.

Thirdly, the profitability ratios. The creditors (long term/short term), the owners & the management of the company. The management is eager to measure its operations efficiently. Similarly, owners invest their in the expectation of reasonable returns. Both these factors depend ultimately on the profits earned by it which can be measured by its profitability ratios.

Profitability ratios can be determined on the basis of either sales or investments.

1) Related to sales:
   a) Profit margin [gross & net]:- It measures the relationship between profit & sales of a firm.
   b) Expenses ratio: - It measures the relationship between expenses like administration, selling & distribution, financial etc & the sales of the firm.

2) Related to investments:-
   a) Return on investments
      i) Return on assets [compare net profits & assets].
      ii) Return on capital employed [compare profits & capital employed]
      ii) Return on shareholder's equity [measure the returns on owner's funds]

Q. What is the effect of the following on the funds flow statement?

Ans. Transfer to reserve: Transfer of profits to general reserve the journal entry is

Profit and loss appropriation a/c Dr
To general reserve a/c

This transaction affects
i) profit and loss appropriation a/c
ii) general reserve a/c

Both the accounts belong to the non current category and hence there is no flow of fund. Increase in any of the reserves on account of transfer from P&L a/c is to be added back to the profits to ascertain funds from operations. If increase is on account of adjustment of profits on non current accounts it would not affect the fund. Similarly if the decrease in reserves is on account of adjustment of loss on non current assets, it would not affect the funds.

a) Depreciation: It means decrease in the value of asset due to wear and tear, lapse of time, obsolescence. Depreciation is taken as an operating expense. While calculating funds from operations the accounting entries are

i) Depreciation a/c Dr.
To fixed assets a/c

ii) Profit and loss a/c Dr.
To depreciation a/c

Thus effectively the P&L a/c is debited while the fixed asset a/c is credited with the amount of depreciation. Since both P&L a/c and the fixed asset a/c are non current accounts depreciation is a non fund item. It is neither a source nor an application of funds. It is added back to operating profit to find out funds from operation. Since it has already been charged to profit but it does not decrease funds from operations. Depreciation should not, therefore be taken as a source of funds.

However depreciation can be taken as a source of funds in a limited sense. This is mainly because it helps to consumer funds by reducing the profits available for dividends and also by reducing the tax liability. Depreciation charge unlike other expense is paid by the company to itself. Therefore depreciation is reduced as a non cash item and it does not affect the funds from operations of an accounting period.

b) Proposed dividend: It may be taken as a current liability. In such a case it will appear as one of the items decreasing working capital in the schedule of changes in working capital. It will not be shown as an application of funds when dividend is paid later on.

Proposed dividend may simply be taken as an appropriation of profit. In such a case proposed dividend for the current year will be added it to current year's profit in order to find out the funds from operation if such amount of dividend has already been charged to profits. Proposed dividend will be shown as an application of funds.

c) Interim dividend: Payment of dividend is an application of funds. In the case of interim dividend the following entry is passed

Interim dividend a/c Dr
To bank a/c

Interim dividend is transferred to P&L a/c by the following entry

P&L a/c Dr
To interim dividend a/c

The composite entry is
P&L a/c Dr
To bank a/c

As the transaction affects the P&L a/c (a non current item). Payment of interim dividend results in application of funds.

d) Provision of tax: It is an application of funds and as such it appears in the funds flow statement. Provision for tax may be treated as a current liability. When tax provision is treated as a current liability, it forms a part of the working capital calculations. In that case tax paid will not be treated as an application of funds.

The second alternative is to treat provision for tax as a non current liability. In that case the following entries are passed
P&L a/c Dr
To provision for tax a/c

When the assessment is completed and tax is paid the amount of tax paid is debited to provision for tax and is treated as an application and the following entry is passed
Provision for tax a/c Dr.
To bank a/c

Q. What are the precautions to be taken during trend analysis?

Ans. During the calculation of trend analysis the following precautions should be taken:

i) There should be consistency in the principles and practices followed by the organizations through out the period for which analysis is made.
ii) The base year should be normal i.e. representative of the items shown in the statement.
iii) It should be calculated only for the items which are having logical relationship with each other.
iv) It should be studied after considering the absolute figures on which they are based.
v) Figures of the current year should be adjusted in the light of price level changes as compared to the base year before calculating trend analysis.

vi) The changes in financial data can understood clearly when the % of change interpreted concurrently with the absolute change.
vii) The changes in incomes should always be studied in the light of changes in expect items.
viii) Changes should be interpreted with some reservations.
ix) The interpretation of the statements should be done in the light of all possible factors which might have brought about such changes.

Thus the above precautions have to be taken during the calculations of trend analysis.

Q. Give any three objectives of financial analysis?

Ans. Financial management analysis is an integral part of interpretations of results disclosed
by financial statements. It supplies to decision makers crucial financial information and points out the problem areas which can be investigated financial statement analysis involves regrouping of the data suitably by arithmetic operations. Financial statements may be analyzed with a view to achieve the following purposes:

1) Profitability analysis: Users of financial statements may analyze financial statements to decide past and present profitability of the business. Prospective investors may do profitability analysis before taking a decision to invest in the shares of the company.

2) Liquidity analysis: Suppliers of goods moneylenders and financial institutions may do liquidity analysis to find out ability of the company to meet its obligations. Liquid assets are compared with the commitments in order to test liquidity position of a company.

3) Solvency analysis: It refers to analysis of long term financial position of a company. This analysis helps to the ability of a company to repay its debts. For this purpose, financial structure, interest coverage is analyzed.

Q. Differentiate between static and dynamic analysis.
Ans.

SR.NO	Dynamic analysis	Static analysis

1.	It requires financial statements of 2 or more years.	It requires financial statements of one year.
2.	It gives information in absolute as well as percentage form.	It gives information in percentage form only.
3.	It deals with same item of different years.	Ti deals with different items of the same year.
4.	It is used for times series analysis.	It is used for cross section analysis.

Q. State any 3 uses of common size statement, comparative statement, trend analysis and ratio analysis?

Ans.<u>Use of common size statement</u>:

1. Common size analysis reveals the sources of capital and all other sources of funds and the distribution or use or application of the total funds in the assets of a business enterprise.
2. Comparison of common size statements over a number of years will clearly indicate the changing proportions of the various components of assets, liabilities, costs, net sales and profits.
3. Comparison of common size statements of 2 or more enterprises in the same industry or that of an enterprise with the industry as a whole will assist corporate evaluation and ranking.

<u>Uses of comparative statement:</u>

1. These statements are very useful to the financial analysts because they indicate the direction of the movement of the financial position and performance over the years.

2. These statements can also be used to compare the position of the firm every month or every quarter. They can be prepared to facilitate comparison with the financial position of other firms in the same industry or with the average performance of the entire industry. Such comparisons facilitate identification of 'trouble spots' in a company's working and taking corrective measures.

3. Comparative statements present a review of the past activities and their cumulative effect on the financial position of the concern.

<u>Uses of trend analysis:</u>

1. Trend analysis indicate the increase or decrease in an accounted item along with the magnitude of change in percentage which is more effective than absolute data.

2. The trend analysis facilitates an efficient comparative study of the financial performance of a business enterprise over a period of time.

Uses of ratio analysis:

1. The relation between 2 or more financial data brought out by an accounting ratio is not an end in itself. They are means to get to know the financial position of an organization.

2. Industrial ratios may provide valuable information only when they are studied and compared with several other related ratios.

3. Ratio analysis will tend to be more meaningful when certain standards and norms are laid down so that what the ratios indicate can be compared with the said standards.

Q. Difference between fund flow and cash flow statement.

	Cash flow statement	Fund flow statement
1.	It shows net change in the position of cash and cash equivalents.	It shows change in the position of working capital.
2.	Cash flow statement is based on narrower concept of funds i.e. cash and cash equivalent.	Fund flow statement is based on broader concept of funds i.e. working capital.
3.	It is now mandatory for all the listed companies and is ◆more widely used in India or abroad.	It is not mandatory and it is not being used by the companies.
4.	Cash flow statement classifies and highlights the cash flows into 3 categories 'operating activities', 'investing activities', and 'financing activities'.	Whereas such a meaningful classification is not used in fund flow statement.
5.	In cash flow statement of changes in working capital is not prepared as the changes in working capital are adjusted for ascertaining cash generated from operations.	In fund flow statement of changes in working capital is prepared.
6.	In cash flow statement decrease in current liability or increase in current asset results in decrease in cash and vice-versa.	In fund flow statement decrease in current liability or increase in current asset brings increase in working capital and vice-versa.

TREASURY BILLS:

Treasury bills are obligations of the government. They are sold on a discount basis for that reason. The investor does not receive an actual interest payment. The return is the difference between the purchase price and the face (par) value of the bill.

The treasury bills are issued only in bearer form. They are purchased, therefore, without the investor's name upon them. This attribute makes them easily transferable from one investor to the next. A very active secondary market exists for these bills. The secondary market for bills not only makes them highly liquid but also allows purchase of bills with very short maturities. As the bills have the full financial backing of the government, they are, for full practical purposes, risk free. This negligible financial risk and the high degree of liquidity make their yield lower than on marketable securities. Due their virtually risk-free nature and because of active secondary market for them, treasury bills are one of the most popular marketable securities even though the yield on them is lower.

What are inter- corporate deposits?

A deposit made by one company to another normally for a period up to 6 months is referred to as an inter-corporate deposit. Such deposits are usually of three types:

1. **Called deposits:** In theory a called deposit is withdraw able by the lender on a day's notice. In practice, however the lender has to wait for at least three days. The interest rate on such deposits may be around 16% p.a.

2. **3 months deposits:** More popular in practice, these deposits are taken by borrower to tide over a short term cash inadequately that may be caused by one or more of the following factors, disruption in production, excessive imports of raw materials, tax payments, delay in collection, dividend payable and planned capital expenditure. The interest rate on such deposit is around 80% p.a.

3. **6 months deposits:** Normally, lending companies do not extend deposits beyond this time frame. Such deposits usually made with first class borrowers carry an interest rate of around 20%p.a.

Characteristics of inter-corporate deposits market:

It may be interest to note the following characteristics of the inter-corporate deposit market:

Lack of regulation: The lack of legal hassles and bureaucratic red tape makes and inter-corporate transaction very convenient. In a business environment otherwise characterized by a plethora of rules and regulations, the evolution of the inter-corporate market is an example of the ability of the corporate sector to organize itself in the reasonably orderly manner.

Secrecy: The inter-corporate deposit market is shrouded in secrecy. The brokers regard their lists of borrowers and lenders as guarded secrets. Tightlipped and circumspect, they are some what reluctant to talk about their business. Such disclosures, apprehend would result in unwelcome competition and undercutting of rates.

Importance of personal contracts: Brokers and lenders argue that they are guided by reasonably objective analysis of the financial situation of the borrowers. However the truth is that lending decisions in the inter-corporate deposits market are based on personal contacts and market information which may lack reliability. Given the secrecy that shrouded this operation and the non-ability of hard data can it be otherwise?

Discount of bills:

A bill arises out of a trade transaction. The seller of goods draws the bill on the purchaser. The bill may be either clean or documentary (a documentary bill is supported by a document of title to goods like a railway receipt or a bill of lading) & may be payable on demand or after a usance period which does not exceed 90 days. On acceptance of the bill by the purchaser the seller offers it to the bank for discount/ purchase. When the bank discounts/ purchases the bill it releases the funds to the seller. The bank presents the bill to the purchaser (the acceptor of the bill) on the due date& gets its payment.

The reserve bank of India launched the new bill market scheme in 1970 to encourage the use of bills as an instrument of credit. The objective was to reduce the reliance on the cash credit arrangement because of its amenability to abuse. The new bill market scheme sought to promote an active market for bills as a negotiable instrument so that the lending activities of a bank could be shared by the other banks. It was envisaged that the bank, when short of funds, would sell or rediscount the bills that it has purchased or discounted. Likewise, a bank which has surplus funds would invest in bills. Obviously for such a system to work there has to be lender of last resort who can come to the succour of the banking system as a whole.

This role naturally has been assumed by the reserve bank of India, which rediscounts bills of commercial banks upto a certain limit. Despite the blessings & support of the reserve bank of India, the new bill market scheme has not functioned very successfully in practice.

Objectives of cash management

Motives for holding cash

1. **Transaction motive**

   Firms need cash to meet their transaction needs. The collection of cash (from sale of goods and services, sale of assets, and additional financing) is not perfectly synchronized with the disbursement of cash (for purchase of goods and services, acquisition, of capital assets, and meeting other obligations. Hence, some cash balance is required as a buffer.

2. **Precautionary motive**

   There may be some uncertainty about the magnitude and timing of cash inflow from sale of goods and services, sale of assets, insurance of securities. Like wise, there may be uncertainty about cash inflow on account of purchases and other obligations. To protect itself against such uncertainties a firm may require some cash balance.

3. **Speculative motive**

   Firms would like to tap profit making opportunities arising from fluctuations in commodity prices, securing prices, & interest rates. Cash-rich firms is better prepared to exploit such bargains may carry additional equity. However for most firms their reserve borrowing capacity & marketable securities would suffice to meet their speculative needs.

What is cash operating cycle?

The operating cycle can be shortened by the following means.

1. **Raw materials procurement:**
   One should have a good supply network. This means that he should have a supplier who can provide him with his raw material requirement at the right time, place and in the required quantity at minimum amount of time. Thus this also implies that he should be in possession of automated machines in case the raw materials are large and bulky .this helps in reducing the time required for the transport and movement of the goods from one place to another.

2. Production process:

In the production process there should not be any time lag from the time of actually receiving the raw materials and the starting of production process. This means as soon as the materials arrive they should be introduced in the production process. This therefore meant that the company will be following the just in time policy(JIT) which simply means that the requirements of the company will be fulfilled at the time required thus reducing the work in progress and thus increasing the efficiency of the company.

3. Finished goods:

The goods once produced should be held in the company's possession as the company's capital would be locked up in these goods. Thus it is essential that the company sell all these finished goods as soon as possible so as to allow the company reacquires its capital employed in the operating cycle.

4. Receipt of sales:

The receipts of the money from the debtors as soon as possible so as to regain the money along with the profits.

This is how the operating cycle operates along with how it can be improved so as to enable the company to regain the money invested in the production of the goods being produced.

Marketable investments: - Marketable investments are those investments which are acquired by the company by the employing its surplus funds or cash temporarily. These investments are short term in nature. These investments can be disposed off by the company at its free will and thus convert it into cash as and when the need arises. Hence, these investments are considered as good as cash, and are often called 'secondary cash resources'. such investments are grouped under "current assets".

Options for investing surplus funds

- **Shares and debentures**: - the company invests its surplus funds in the outside corporate securities. i.e. shares and debentures of other companies. The company gets dividend and interest from these idle investments.

- **Government bonds**: - The company can invest its surplus funds in the various government bonds which will earn them some returns. These bonds not only beneficial to the government but also to the corporate business people.

- **Intercorporate deposits**: - The company can also invest its surplus funds with another company via deposits these sorts of deposits are called imtercorporate deposits, the company earns interest on these investments.

- **Expansion: -** the company can also utilize its surplus funds by employing it in it the same business for further expansion of the business. Expansion of these businesses leads directly or indirectly through their surplus.

Types of Marketable Securities

Commercial paper:

Commercial paper consists of short term unsecured promissory notes issued by finance companies and certain industrial concerns. Commercial paper can be sold either directly or through dealers. Many large scale companies have found it profitable because of the volume, to sell their papers directly to investors, thus bypassing dealers. Among companies selling papers on this basis are General Electric Credit Corporation and the Ford Motor Credit Company. Paper sold through dealers is issued by industrial companies and smaller finance companies. Dealers very carefully screen the creditworthiness of potential issuers. In a sense, dealers stand behind the paper they place with investors.
Rates on commercial paper are somewhat higher than rates on treasury bills of the maturity and about the same as the rates available on banker's acceptance. Paper sold directly generally commands a lower yield than a paper sold through dealers. Usually, commercial papers are sold on discount basis, and maturity generally ranges from 30 -270 days. Most paper is held to maturity, for there is essentially no secondary market.0ften direct sellers of commercial papers will repurchase the paper on request… arrangements may also be made through dealers for repurchase of paper sold through them. Commercial paper is sold only in large denominations, usually $100,000.

Negotiable certificate of deposit:

A short term investment, the certificate (CD) is evidence of the deposit of funds at a commercial bank for a specified period of time and at a specified rate of interest. The most common denomination is $100,000, so its appeal is limited to large investors. Money market banks quote rates on CDs; these rates are changed periodically in keeping with changes in money market rates. Yields on CDs are greater than those on treasury bills and repose and about the same as those on banker's acceptances and commercial paper. Original maturities of CDs generally range from 30-360 days. A good secondary market has developed for the CDs of the large money market banks; default risk is that of the bank rating. Like bankers acceptances, corporations buy domestic as well as CDs of large foreign banks. The latter is known as “YANKEE” CDs, and they typically carry a higher expected return.

Eurodollars:

Although most Eurodollars are deposited in Europe, the term applies to any dollar deposit in foreign banks or in foreign branches of U.S banks. There exists a substantial, very active market for deposit and leading of Eurodollars. This market is a wholesale one in that the amounts involved are at least $ 100000. Moreover the market is free of government regulations, as it is truly international scope.

The rates quoted on deposits vary according to the maturity of the deposit, while the rates on loans depend on maturity and default risk. For a given maturity, the leading rate always exceeds the deposit rate. The bank makes it money on the spread. The benchmark rate in this market is 6-month London interbrain offer rate. (LIBOR). This is the rate at which banks make loan to each other. All others borrowers are quoted rates in excess of this rate, such as LIBOR + 1\2 PERCENT.

As a marketable security, the Eurodollar time deposit is like a negotiable certificate of deposit. Most deposit have a maturity of, less than a year, and they can be sold in the market prior to maturity. Call money deposits are available, allowing investors to get their money back on demand, and there are 1-day (overnight) deposits. For the large corporation with ready contact with international money centers, the Eurodollar deposit usually is an important investment.

Short term municipals:

State and local governments are increasingly providing securities tailored to the short term investors. One is a commercial paper type of instrument, where the interest rates reset every week. That is, the security is essentially floating rate where the weekly reset ensures that market value ill vary scarcely at all. Some corporations invest in longer term municipal securities, but the maturity usually is kept within one or two years. A problem with longer term instruments designed for the corporate treasurer and for municipal market mutual funds have much better marketability and price stability.

Factors Determining Cash Needs:

The working capital needs of a firm are influenced by numerous factors. The important ones are:

- Nature of business.

- Seasonality of operations.
- Production policy.
- Market conditions.
- Conditions of supply.

Nature of business:

The working capital requirement of a firm is closely related to the nature of its business. A service firm, like an electricity undertaking or a transport corporation which has a short operating cycle and which sells predominantly on cash basis, has a modest working capital requirement. On the other hand, a manufacturing concern likes a machine tools unit, which has a long operating cycle and which sells largely on credit, has a very substantial working capital requirement.

Seasonality of operations:

Firms which have marked seasonality in their operations usually have highly fluctuating working capital requirements. To illustrate, consider a firm manufacturing ceiling fans. The sale of ceiling fans reaches a peak during the summer months and drops sharply during the winter period. The working capital need of such firm is likely to increase considerably in summer months and decrease significantly during the winter period. On the other hand, a firm manufacturing product like lamps, which have even sales round the year, tends to have stable working capital needs.

Production policy:

A firm marked by pronounced seasonal fluctuation in its sales may pursue a production policy which may reduce the sharp variations in working capital requirements. For example, a manufacturer of ceiling fans may maintain a steady production throughout the year rather than intensify the production activity during the peak business season. Such a production policy may dampen the fluctuations in working capital requirements.

Market conditions:

The degree of competition prevailing in the market has an important bearing on working capital needs. When competition is keen, a larger inventory of finished is required to promptly serve customers who may not be inclined to wait because other manufacturers are ready to meet their needs.

Further, generous credit terms may have to be offered to attract customers in a highly competitive market. Thus, working capital needs tend to be high because of greater investment in finished goods inventory and accounts receivable.

If the market is strong and competition weak, a firm can manage with a smaller inventory of finished goods because customers can be served with some delay. Further, in such a situation the firm can insist on cash payment and avoid lock-ups of funds in accounts receivable –it can even ask for advance payment, partial or total.

Conditions of supply:

The inventory of raw materials, spares, and stores on the conditions of supply. If the supply is prompt and adequate, the firm can manage with small inventory. However, if the supply is unpredictable and scant, then the firm, to ensure continuity of production, would have to acquire stocks as and when they are available and carry large inventory on an average. A similar policy may have to be followed when the raw material is available only seasonally and production operations are carried out round the year.

Floating-rate preferred stock:

Straight preferred stock is a perpetual security where the dividend can be omitted by the issuer when its financial conditions deteriorate. For these reasons, usually we do not think of it as being suitable for marketable security portfolio of a corporation. However, the corporate investor gains a considerable tax advantage, in that 70 percent of the preferred stock dividend is exempt from federal taxation (in U.S.A.). (The full dividend is subject to state income taxation).

Floating-rate preferred stock, as the name implies, provides a yield which goes up or down with money market values. It also permits the corporate investor to reap the advantage of the 70 percent dividend is exempt from federal tax purposes. One product in this vein is money market preferred stock (MMP). How does it work?

With MMP, an auction is held every 49 days. This provides the investor with liquidity and relative price stability as far as interest rate risk goes. It does not perfect the investor against default risk. The new auction rate is set by the forces of supply and demand in keeping with interest rates in the money market. A typical rate might be 0.75 times the commercial rate, with more creditworthy issuers commanding an even greater discount.

As long as enough investors bid at each auction, the effective maturity date is 49 days. As a result, there is little variation in the market price of the instrument over time. The auction where there are insufficient bidders, there is default rate for one period that is frequently 110 percent of the commercial paper rate. In addition, the holder has the option to redeem the instrument at its face value.

These provisions are attractive to the investor as long as the company is able to meet the conditions. If the company should altogether default, however the investor loses. There have been only a few instances of failed auctions and default.

Portfolio Management:

The decision to invest excess cash in marketable securities involves not only the amount to invest but also the type security in which to invest, to some extent, the two decisions are interdependent. Both should be based on evaluation of expected net cash flows and the uncertainty associated with these cash flows. If future cash –flow patterns are known with reasonable certainty and the yield curve is upward sloping in the sense of longer term securities yielding more than shorter term ones, a company may wish to arrange its portfolio so that securities will mature approximately when the funds will be needed. Such a cash flow pattern gives portfolio, for it is unlikely that significant amounts of securities will have to be sold unexpectedly.

What are the benefits of holding cash?

These are various reasons that a company may want to hold cash. Some of the important reasons for holding cash would be to meet immediate and unexpected expenses that may arise during the course of the running of the business. Some of these expenses may be attributed to the spending on stationery or may be on other such miscellaneous such as purchase of beverages of refreshments for any of the company's guests.

Q. Explain the implementation of an improvement in the current ratio from 1 in 1999 to 2.5 in 2000.

Ans) The current ratio is the ratio of current assets to current liabilities. The current ratio of a firm measures its short-term solvency, that is, its ability to meet short-term obligations. As a measure of short term/current financial liquidity, it indicates the rupees of current assets available for each rupee of current liability/obligation.

The higher the current ratio, the larger is the amount of rupees available per rupee of current liability, the more is the firms ability to meet current obligations and greater is the safety of funds of short term creditors.

So, the increase in current ratio from 1 in 1999 to 2.5 in 2000 indicates good liquidity position of the firm. It indicates that firm has greater working capital to meet its day to day requirements. The firm can meet its short-term obligations effectively.

Increase in current ratio means increase in current assets, which may be either stock or cash or debtors. Increase in stock or any other current asset indicates good short-term solvency of the firm.

The standard current ratio is 1.33:1 and the firm's current ratio has increased from 1 in 1999 to 2.5 in 2000. It indicates that the firm is improving its current ratio. The firm had current ratio of 1:1 i.e. for every one rupee of current liabilities current assets of one rupee are available to meet them. But the firm's current ratio of 2.5:1 in the year 2000 indicates that for every one rupee of current liability, the firm has two and a half times current asset to meet them, which means more working capital.

This will improve short-term solvency of the firm. The increase in the current ratio may also due to decrease in current liabilities i.e. creditors, bills payable, etc.

Q. Which of the financial ratios of a company would you most likely, refer to in each of the following situations? Give reasons.

a) The company asks you to sell material on credit

In this situation, the short-term solvency position of the company should be determined. The short-term solvency position is determined by current ratio. The current ratio is a test of the credit strength and solvency of an organization. It indicates the company's ability to meet its day to day financial obligations. Also the liquid ratio should be considered to know the immediate solvency position of the company. This ratio shows the firms ability to meet its immediate obligations promptly. It is necessary to know the immediate solvency position, as these are possibilities of becoming cash-insolvent in a very short time, if major parts of the current assets are locked in inventories.

* Debtors turnover is very important.

b) You are thinking of investing Rs. 25000 in the company's debenture

In the above situation, the long-term solvency position of the company should be determined. The proprietary ratio and debt equity ratio determines the long-term solvency position of the company. The two points which should be considered in the given condition

i) Interest to be paid on time.

ii) Investments to be secured (assured return)

The proprietary ratio is a test of the financial and credit strength of the business. It relates shareholders funds to total assets i.e. total funds. This ratio determines the long term or ultimate solvency of the company. In other words, proprietary ratio determines as to what extent the owner's interests and expectations are fulfilled from the total investments made in the business operation. The debt service ratio will also be considered. This ratio is also called as interest coverage ratio.

The purpose of this ratio is to find out the number of times the fined financial charges are covered by income before interest and tax. It indicates whether the company will earn sufficient profits to pay periodically the interests charges. Higher the ratio it is favorable. It shows that the company will be able to pay interest regularly.

c) You are thinking of investing Rs.25000 in the company's share.

In this situation, the company should refer to earning per share ratio and price earning ratio. The 2 main points to be considered under this content are

1) Payment of dividend

2) Appreciation of investment

Earnings per share represent earnings of the company whether or not dividends are declared. If there is only one class of shares, the earnings per share are determined by dividing net profit by the number of equity shares. If there are both equity and preference shares the net profit should be reduced by the amount necessary to pay preference dividend. It indicates the possibility of issue of bonus share in future. In short, the ratio is used by the investors for evaluating the investment opportunities. It shows effective utilization of equity capital.

Price earning ratio should also be referred to as it shows whether the shares of a company are under or over valued. The ratio helps the investors in deciding about the purchase of shares of a company at a particular market price. Higher ratio indicates that the investors are satisfied that the future earnings per share will increase.

*Return on shareholders fund.

*Debt equity ratio.

Q. Explain the solvency and profitability ratios.

Ans.

I. <u>SOLVENCY RATIOS</u>: These ratios analyze short term and immediate financial position of a business organization and indicate the ability of the firm to meet its short term commitments (Current Liabilities) out of its short term resources (Current Assets) also known as Liquidity or Credit Ratios. Solvency Ratios includes:

1) <u>Long Term Solvency ratios:-</u>

a) Proprietary Ratios ⇒ Proprietary Ratio is a test of financial and credit strength of the business. It relates shareholders funds to total assets i.e. Total funds. This ratio determines the long term or ultimate solvency of the company.

$$\textbf{Proprietary Ratio} = \frac{\textbf{Proprietors Funds}}{\textbf{Total Funds}}$$

b) Debt Equity ⇒ it expresses the relation between the external equities and internal equities or the relationship between borrowed capital and owners capital.

$$\textbf{Debt Equity Ratio} = \frac{\textbf{Debt}}{\textbf{Debt + Equity}}$$

c) Capital Gearing Ratio ⇒ Capital Gearing Ratio brings out the relationship between two types of capital i.e. capital carrying fixed ratio of interest or fixed dividend and capital that does not carry fixed rate of interest or fixed dividend.

$$\textbf{Capital Gearing Ratio} = \frac{\textbf{Securities bearing fixed rate of interest}}{\textbf{Shareholders fund}}$$

2) <u>Short Term Solvency ratios: -</u>

a) Current Ratio ⇒ Current Ratio is also known as the 'Working Capital Ratio', 'Solvency Ratio' or '2 in 1 Ratio'. This ratio expresses the relationship between current assets and current liabilities.

$$\textbf{Current Ratio} = \frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$$

b) Quick Ratio ⇒ Quick ratio is also known as 'Liquid Ratio' or 'Quick Assets Ratio' or 'Acid Test Ratio' or 'Near Money Ratio' or '1 to 1 Ratio'. This ratio is designed to indicate the liquid financial position of an enterprise. Thus, the ratio shows the firms ability to meet its immediate obligations promptly. It measures the relationship between quick assets and quick liabilities.

$$\textbf{Quick Ratio} = \frac{\textbf{Quick Assets}}{\textbf{Quick Liabilities}}$$

II. PROFITABILITY RATIOS:

These ratios are intended to reflect the overall efficiency of the organization, its ability to earn a reasonable return on capital employed or on shares issued and the effectiveness of its investment policies. Profitability Ratios includes:

1) Product

a) Gross Profit Ratio ⇒ Gross profit brings out the relationship between gross profit and net sales. It is also known as 'Turnover Ratio' or 'Margin' or 'Gross Margin Ratio' or 'Rate of Gross Profit'. It is expressed as % of net sales.

$$\textbf{Gross profit} = \frac{\textbf{Gross Profit}}{\textbf{Sales}} \times \textbf{100}$$

b) Net Profit Ratio ⇒ Net Profit Ratio indicates the relationship between net profit and net sales. Net profit can be either operating net profit or net profit after tax or net profit before tax. This ratio is known as 'Margin or Sales Ratio'.

Net Profit can be calculates as:-

$$\frac{\textbf{Net Profit After Tax}}{\textbf{Net Sales}} \times \textbf{100}$$

$$\frac{\textbf{Net Profit Before Tax}}{\textbf{Net Sales}} \times \textbf{100}$$

c) Operating Ratio ⇒ Operating Ratio is the relationship between cost of activities and net sales. This ratio brings out the relationship between total costs of goods sold to net sales.

$$\text{Operating Ratio} = \frac{\text{Operating Cost}}{\text{Net Sales}} \times 100$$

2) Investment

a) **Return on Capital Employed** ⇒ This ratio explains the relationship between total profits earned by the business and total investments made or total assets employed. This ratio thus measures the overall efficiency of business operations. This ratio is alternatively known as 'Return on Total Sources'.

$$\text{Return on capital employed} = \frac{\text{Net profit before interest and tax}}{\text{Capital employed}} \times 100$$

b) **Return on Proprietors Fund** ⇒ This ratio is alternatively known as 'Return on Proprietors Equity' or 'Return on shareholders investment' or 'Investors Ratio'. The ratio indicates the relationship between net profit earned and total proprietors funds.

$$\text{Return on Proprietors Fund} = \frac{\text{Net Profit After Tax}}{\text{Proprietors Funds}} \times 100$$

c) **Return on Equity Share Capital** ⇒ This ratio indicates the rate of earning on the equity or ordinary share capital. This is expressed as a % or in absolute monetary terms. Alternatively, this may be expressed as an amount of return per equity share but as a % of the equity capital, it is easily understood. This ratio is also known as 'The Rate of Return on Equity Capital'.

$$\text{Return on Equity Share Capital} = \frac{\text{NPAT} - \text{Preference Dividend}}{\text{Equity Shares Capital}}$$

d) **Earning per share** ⇒ Earning peer share is calculated to find out overall profitability of the organization. Earnings per share represent earnings of the company whether or not dividends are declared. If there is only one class of shares, then EPS are determined by dividing net profit by the no. of equity shares. If there are both equity and preference shares the net profit should be reduced by the amount necessary to pay preference dividend.

$$\text{Earnings per share} = \frac{\text{NPAT} - \text{Preference Dividend}}{\text{No. of Equity shares}}$$

e) **Dividend Payout Ratio** ⇒ The purpose of this ratio is to find out the proportion of earning used for payment of dividend and the proportion of earning retained. The ratio is the relationship between earning per equity share and dividend per equity share.

$$\textbf{Dividend Payout Ratio} = \frac{\textbf{Dividend per equity share}}{\textbf{Earning per equity share}}$$

Q. Importance of cash flow statement.

Ans. 1) An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.

2) Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash for essentially the same reasons, however, different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

Q. Funds from operation:

A. It is working capital flow arising out of operating activities. Incase of non-cash items it is decided without considering the effect of non-cash operating items as these items represent only book entries. Incase of non-operating items it is decided without considering the effect of non-operating items, as these items are not relating to operating activities.

Q) **Name any 5 sources of funds & classify them into short-term & long -term funds?**

Ans.)

- ✓ Issue of equity share & preference shares = Long- term funds.
- ✓ Issue of debentures = Long- term fund.
- ✓ Receipt of public deposits & other unsecured loans = Short- term fund.
- ✓ Receipt of securities premium = Short- term fund.
- ✓ Income from long-term investments = Long-term funds.

Q) Name 3 short-term & 3 long-term applications of funds?

Ans.)

<u>Short term application of funds</u>

1. Premium paid on redemption of preference shares & debentures.

2. Extra ordinary payments & non-recurring losses.
3. Repayment of temporary loan secured & unsecured.

Long term application of funds

1. Redemption of preference shares & debentures.
2. Purchase of fixed assets.
3. Purchase of investments.

Q) Uses of fund flow statements:
Ans.)

- Fund flow statements are prepared for internal & external uses.
- They are designed to assess the funds available, forecast cash requirements & to evaluate the investments & financial decisions of a business entity.
- There are many parties who are interested in the funds flow statements. Shareholders, investors, bankers, creditors & the management are among them.
- Primarily, the funds flow statements is to identify the sources & applications of funds.

Q) Importance & short comings of fund flow statement:

Ans.)
Funds flow statement is a financial statement, which shows as to how a business entity has obtained its funds & how it has applied or employed its funds between the opening & closing balance sheet dates(during the particular year/period.

Importance of funds flow statement:

Funds flow statement is an important analytical tool for external as well as internal uses of financial statements. The users of funds flow statement can be listed as under:

1. **Managements** of various companies are able to review cash budgets with the aid of funds flow statements. They are extensively used by the

management in the evaluation of alternative finance & investments. In the evaluation of alternative finance & investment plans, funds flow statement helps the management in the assessment of long-range forecasts of cash requirements & availability of liquid resources. The management can judge the quality of management decisions.

2. **Investors** are able to measure as how the company has utilized the funds supplied by them & its financial strength with the aid of funds statements. They gauge can the company capacity to generate funds from operations. On the basis of comparative study of the past with the present, investors can locate & identify possible drains on funds in the near future.

3. Funds statement serve as effective tools **to the management** for economic analysis as it supplies additional information, which cannot be provided by financial statements, based on historical data.

4. Fund statement explains **the relationship between changes in working capital & net profits**. Funds statement clearly shows the quantum of funds generated from operations.

5. Funds statement helps in the **planning process** of a company. They are useful in assessing the resources available and the manner of utilization of resources.

6. Funds statement explains the **financial consequences** of business activities. They provide explicit & clear awareness to questions regarding liquid & solvency positions of the company, distribution of dividend & whether the working capital has been effective or otherwise.

7. Management of companies can forecast in advance the requirements of additional capital & can plan its capital issue accordingly.

8. Fund statement provides clues to the **creditors & financial institutions** as to the ability of a company to use funds effectively in the best interest of the investors, creditors & the owners of the company.

9. Funds statement indicates the **adequacy or inadequacy of working capital.**

10. The information contained in fund flow statement is more **reliable, dependable & consistent** as it is prepared to include funds generated from operations & not net profit after depreciation.

11. Funds flow statement clearly indicate how profits have been invested, whether investments in fixed assets or inventories or ploughed back.

Q) The liquidity of a business is explained by cash flow statement. Discuss.

Ans.)

In making plans for the more immediate future (short-range financial planning) the management is vitally concerned with a statement of cash flows which provides more detailed information. Such a statement is useful for the management to assess its ability to meet obligations, to trade creditors, to pay bank loans, to pay interest to debenture holders & dividend to its shareholders.

Furthermore the projected cash flow statements prepared month-wise or so can be useful in presenting information of excess in some months & shortage of cash in others . By making available such information in advance, the statement of cash flows enables the management to revise its plans. Cash flow statements summarizes sources of cash inflows & uses of cash outflows of the firm during a particular period of time.

In the preparation of cash flow statement all the item that increase/decrease cash are included but all those items that donot have any effect on cash are excluded. Hence, it is essentially a tool of short term financial planning. Cash flow information is useful in assessing the ability of company.

Q) What do you mean by liquidity funds. How can the liquidity of a firm be assessed?

Ans.) Liquidity of funds means the availability of liquid cash to meet the immediate commitments. It helps in analyzing the liquidity position of the firm .Furthermore; we can assess the liquidity of the firm by liquidity ratios. These ratio analyses short term immediate financial position of a business organization & immediate ability the firm to meet its short term commitments. The (current liability) out of its short term resource (current assets). That is also known as **solvency ratio** which helps the firm to meet its immediate obligations promptly.

It measures the relationship between the Quick assets & Quick liabilities.

The quick ratio or liquid ratio is calculated by dividing Quick assets by Quick liabilities.

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Quick liabilities}} \quad \&$$

$$\text{C.R.} = \frac{\text{C.A.}}{\text{C.L.}}$$

It is more of qualitative concept. This ratio is the true test of business or firms solvency & liquidity position & this will indicate the inventory hold-ups when studied along with the current ratio.

Q) The liquidity of a business is explained by cash flow statement. Discuss.

Ans.)

In making plans for the more immediate future (short-range financial planning), the management is vitally concerned with a statement of cash flows, which provides more detailed information. Such a statement is useful for the management to assess its ability to meet obligations to trade creditors, to pay bank loans, to pay interest to debenture holders & dividend to its shareholders. Furthermore the projected cash flow statements prepared month-wise or so can be useful in presenting information of excess in some month & shortage of cash in others. By making available such information in advance, the statement of cash flows enables the management to revise its plans. Cash flow statements summarize sources of cash inflows & uses of cash outflows of the firm during a particular period of time. In the preparation of cash flow statement all the item that increase /decrease cash are included but all those items which have no effect on cash are excluded. Hence, it is essentially a tool of short term financial planning. Cash flow information is useful in assessing the ability of the enterprise to generate cash & cash equivalent & enables users to develop models to assess & compare the present value of the future cash flows of different enterprises.

Q) **What is short-term solvency & long-term solvency ? How do they differ? As a shareholder/debenture holder which will you be concerned about.**

Ans.) The short-term solvency position of company indicates the ability of the company to meet its short-term abilities like payment to creditors, payment of wages & salaries etc.

Short term solvency position is studied by taking into consideration current ratio accompanied by liquid ratio.

Long-term solvency position of a company indicates the ability to meet its long-term liabilities like redemption of debentures, payment of long term loans etc.

Long-term solvency position is indicated by the proprietary ratio & debt equity ratio.

As a shareholder/debenture holder one will be concerned about the long-term solvency position of the company this is because the shareholders/debenture holders invest their money in long-term funds.

Q) Differentiate between static and dynamic analysis

Dynamic Analysis: (Also Called as Horizontal Analysis):

Financial statements for a number of years are reviewed and analyzed. The current years' figures are compared with the standard bases year. The analysis statement usually contains figures for two or more years and changes are shown regarding each item, from the base year, usually in the form of percentage. Such an analysis gives considerable insight into levels and areas of strength and weaknesses. E.g. Trend Analysis.

Static Analysis: (Also Called as Vertical Analysis):

Study of quantitative relationship of the various items in the financial statement on a particular date. For example, the ratios of different items of costs for a particular period may be calculated with the sales for that period. Such an analysis is useful in comparing the performance of several companies in the same group, or divisions or departments in the same company. Since this analysis depends on the data for one period, this is not very conducive to proper analysis of the company's financial position. E.g. Comparative statements
It may be noted that these two types of analysis are not mutually exclusive. They can be done simultaneously also.

1. What is opportunity cost of capital?

Opportunity cost of capital is "the rate of return associated with the best investment opportunity for the firm and its shareholders the will be foregone if the project presently under consideration by the firm were accepted." Its is also called as 'Implicit Cost'. In case of retained earnings, it is the income, which the shareholders could have earned if such earnings would have been distributed and invested by them.

2. Distinguish between cash budget and cash forecast

Cash Budget	Cash forecast
Cash Budget is usually prepared for short periods ranging upto one year.	Cash forecast is for longer terms exceeding one year such as 3 years, 5 years, etc.

Objective is to ensure short term liquidity and avoid default in timely discharge of current liabilities.	Objective is to study sources of funds for various future requirements.
Thrust is on current assets and liabilities and maintaining cash cushion for safety.	Capital receipts and capital expenditure, investments dominate this number game.
Usually prepared by junior management team for perusal of senior managers.	Usually prepared by senior management for perusal of Directors, Owners.
It is working capital management activity.	It is more of investment planning activity.

3. **Distinguish between Cash Flow Statement and Cash Budget:**

Cash Flow Statement	Cash Budget
Cash flow statement is prepared based on past data of Income Statement and Balance sheet.	Cash Budget is prepared based on estimates of collection and outgo of cash.
Is historical in nature.	Is futuristic in nature.
Analytical tool.	Planning tool.
Is based on real data.	Is based on estimates.

4. What are marketable securities?

Marketable securities are short-term investment instruments to obtain a return on temporarily idle funds. They are securities, which can be converted into cash in a short period of time, typically few days. To be liquid, it should have two basic characteristics.

Basic Characteristics of Marketable securities:

Ready market: Ready market reduces amount of time required to convert a security into cash. Ready market should have breadth (large number of participants scattered over large geographical area) and depth (ability to absorb purchase/ sale of large number of securities.)

Safety of principal amount: There should not be any loss of principal amount invested in the security. Then only it is worth investing in such securities. Otherwise, the investing firm is anyway better off maintaining idle cash/ bank balance.

Examples of Marketable securities are: Treasury Bills, Commercial Paper, Banker's Acceptance, Repurchase agreements, Inter-corporate Deposits, Bill Discounting, call market, etc.

5. Lease and hire purchase

Lease: A contract of lease may be defined as "A contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent."

Important features here are:

1. Owner and User are different
2. Depreciation claim is not with the user (lessee) as he is not the owner. Lessor (owner) claims the depreciation.
3. Lease (rent) payment is a tax-deductible expense.
4. In most transactions, asset is delivered directly to the lessee by the manufacturer/ supplier. Lessor makes payment to the supplier and receives rent from lessee in future periods.
5. Lease funded assets do not alter Debt: Equity ratio.

Hire Purchase: In case of Hire Purchase transaction, the goods are delivered by the owner to another person on the agreement that such person pays the agreed amount in periodical installment.

Important features here are:

1. Ownership of the asset is transferred to the buyer only on payment of last installment.
2. Buyer claims depreciation on the asset.

Lease	**Hire Purchase**
Lessor claims depreciation	Buyer claims depreciation
On completion of contract residual (salvage) value goes to Lessor	On completion of contract residual (salvage) value goes to Buyer
In absence of specific agreement otherwise, asset is to be returned to the lessor after the lease period.	Asset is conclusively purchased by the buyer at the end of the agreement period.

Lease payment is fully deductible for tax.	Only interest portion of EMI/ Hire value is tax deductible.

6. ADR, GDR, ECB

ADR: ***American depository receipt*** is a negotiable certificate that represents a company's publicly traded equity or debt. They are created when a broker purchases the company's shares on the home stock market and delivers those to the depository's local custodian bank, which then instructs the depository bank, to issue Depository Receipts. Depository receipts could be traded freely just like any other security, either by exchange or in the over-the-counter market and could be used to raise capital.

GDR -***Global Depository Receipts*** means any instrument in the form of a depository receipt or certificate created by the Overseas Depository Bank outside India and issued to non-resident investors against the issue of ordinary shares or Foreign Currency Convertible Bonds of issuing company.

A GDR issued in America is an *American Depository Receipt (ADR).*

ECB: ***External Commercial Borrowing:*** It is a term loan denominated in foreign currency (eg. $, £). Firms having significant exports to foreign countries earn the respective foreign currency inflow. Hence, it may be beneficial for them to borrow in that currency, especially when interest rates are much lower there. In absence of exports, however, cost of hedging almost nullifies the advantage of lower interest rates.

Points to remember:

Leverages:

- Business Risk is risk due to fixed operating costs (operating leverage)
- Financial Risk is risk due to fixed financial costs (interest, preference dividend) i.e. due to financial leverage.
- Financial Leverage is also called as 'Trading on Equity'
- Direct Costs usually would mean variable costs

Ratio Analysis:

- P/V Ratio is contribution /Sales
- Just 'Turnover Ratio' is 'Capital Turnover Ratio' i.e. Sales/ Capital Employed
- Net Assets = Fixed Assets + (Current Assets – Current Liabilities) = Capital Employed
- Return on Investment (RoI) is
  Return on Capital Employed = Return on Net Assets = PBIT / Capital Employed
  If specified as 'post tax RoI': RoI = [PBIT (1- T)]/ Capital Employed
  {Sometimes RoI is also signified as Return on Total Assets : Use this only if specified this way}
- Debtors Velocity = Debtors Collection Period = ACP
  Debtors Turnover = Sales / Debtors = 12 / ACP_{months} = 360 / ACP_{days}M