UNIT 14 FINANCIAL MANAGEMENT

Structure

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14.0 OBJECTIVES

After reading this Unit you will be able to:

- understand the meaning of financial management,
- know about the various aspects of financial management,
- know about the different terms used in financial management, and
- learn about the importance of raising funds and fund allocation through budgeting.

14.1 INTRODUCTION

Every organization, irrespective of its size or ownership pattern, has to manage its finances. The overall objectives of an organisation cannot be achieved in the absence of financial management. Many organisations fail in their objectives because of financial mismanagement and this failure rate is quite high among the small business enterprises. Hence, financial management is vital for all types of organisations, profit making as well as non-profit making. In the case of non-profit making organisations also the effectiveness and performance depends on their fmancial resources management. This Unit familiarises you with the relevance of financial management and the various aspects related to it. It deals with mobilisation of financial resources, their allocation, importance of accounting and budgeting etc. However, it should be noted here that it is not possible to deal in detail the various aspects of fmancial management in one single Unit as each aspect is a specialisation in itself. Our aim is to provide you with certain basics in this regard.

14.2 FINANCIAL MANAGEMENT

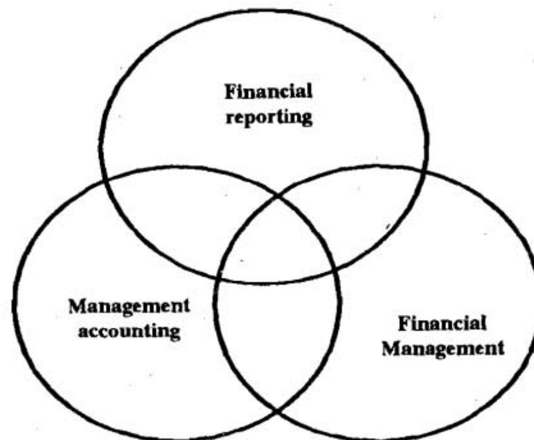
When we attempt to analyse the financial functions of an organisation we find that funds (capital) have, to be:

- procured,
- allocated for various activities,
- used effectively, and
- monitored.

Further, the results of all these have to be recorded also. All this brings to fore a three dimensional financial process:

- Financial Management, ,
- Management Accounting, and
- Financial Accounting

All these three are at the same time separate yet overlapping areas of the financial functions of an organisation.



1) Financial Accounting deals with the measurements and reports of the financial position of the organisation and provides this to external users such as the shareholders, creditors, government agencies, etc.

   "Financial Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results there of'. -American Institute of Certified Public Accountants.

2) Managerial Accounting deals with procuring of data for the organisation's management i.e. to serve the internal users with necessary accounting information to carry out the management tasks of planning, organising, actualising and controlling. "Management Accounting is the presentation of accounting Information in such a way as to 'assist management in the creation of policy and in the day to day operations of an undertaking". - Anglo American Council of Productivity.

3) Financial Management deals with the process adopted by an organisation for taking financial decisions through analysing and interpretation of financial data for meeting the organisations objectives. Hence, the tasks involved in' Financial Management include:

   - analysing financial needs,
   - forecasting financial needs,
   - managing working capital,
   - planning capital structures,
   - organising financial operations, and
   - monitoring and controlling finances etc.

In fact raising funds and allocating funds for business are the two prime financial management tasks. Certain other tasks like financial planning, analysis, etc. revolve around these tasks.

143 FINANCIAL PLANNING

In Block 2, Unit 6 we had defined planning as a management function. Hence, in this, Section we will not go into those details but confine our discussion to what we mean by Financial Planning. In fact Financial Planning is an appraisal of those financial aspects that may or are

likely to occur in future but need immediate decision making. It involves **setting financial objectives in terms of profits, sales or acquisition of assets along with financial forecasting for the organisation.** This includes estimation in the areas of:

- **Capital requirements,**
- **Capital Structure,**
- **Credit Policy, and**
- **Other financial contingencies.**

In fact, Financial Planning is concerned with raising funds and there effective utilisation. The aim here is to maximize the organisation's wealth keeping in view the organisation's objectives.

Generally, Financial Planning is done through budgeting and this also takes care of resource allocation. But before we discuss budgeting we will examine certain others aspects of Financial Management.

14.4 RAISING FUNDS

Both, as a manager as well as an entrepreneur, you must be aware of the capital generation process or what is termed as raising of funds for doing business. It is a function of the manager or entrepreneur to raise financial resources for not only establishing the business but also for operational requirements. Such resources are generated **internally** as well as **externally** and are for **short term** as well as **long term.**

All amounts invested in the business by its owners, partners or proprietor as a basis for operations are termed as capital. In other words capital refers to **all company liabilities and owners equity.** This includes short term as well as long term capital. The sources of short term finances are:

- own capital,
- Borrowing/deposits from friends, relations and others,
- Spontaneous capital through credit facilities from vendors,
- Negotiated credit i.e. short term loans on negotiated basis from commercial banks and finance agencies etc. to be paid back in a specified time.

The long term financial resources include:

- Term loans from banks and other financial institutions,
- Issue of shares and bonds,
- Owners or partners capital,
- loans from government institutions (e.g. Tourism Finance Corporation of India), and
- Deposits of loans given by directors/partners of the organisations.

A good manager will scan the internal as well as external environment at the time of raising funds. Answers to following questions will be of use for sound financial planning while raising funds:

- What are the interest rates on borrowings?
- What is the repayment capacity of the organisation?
- How soon is the organisation likely to make profits?
- Is the return from the investments made by borrowed funds going to be higher than the interest to be paid on borrowings? etc.

In the case of tourism the central as well as many state governments have come out with special loans schemes on liberal terms. Entrepreneurs and small businesses should keep track of such schemes.

14.4.1 Managing Working Capital

Financial Management also involves proper management of the investment of capital in business. Capital investments in any business are of two types:

- investments for permanent or long term purposes (capital structures e.g. acquiring fixed assets, research and development etc.), and
- funds needed for current operations (working capital).

Working capital, in simple terms, refers to that **investment which is needed for day to day business operations and no organisation can function in its absence.** In other words working capital refers to **all current assets and liabilities.** The administration of these current assets and liabilities within the framework of organisation's stated goals is termed as the management of working capital. It is the task of the financial manager to ensure that these financial resources are available to the organisation at the least possible cost and the organisation can timely repay the obligations.

Current assets are stock-in-trade and cover raw materials, finished goods and work in progress.
Current liabilities are all debts due for payment in a year. These include salaries, interest, trade creditors etc.

While managing current liabilities one should remember not to pay bills till they fall due nor pay them unduly late and also negotiate discounts for prompt payment.

The working capital requirements of an organisation cannot be determined through any set of rules or formula. However, the following points are considered to be relevant in this regard:

- the nature and size of business,
- the duration of the manufacturing cycle i.e. the time taken between purchase of raw materials and production of finished goods or services,
- demand fluctuations of the product (this is frequent in Tourism Product)
- the production policy,
- credit terms,
- expansion policy, and
- delivery policy, etc.

14.4.2 Managing Cash

For any business it is essential to have a proper estimation of cash requirements. It has been observed that many organisations, inspite of their profit earnings, become bankrupt in the absence of cash. On the contrary there are organisations with excessive cash which is a waste of resources. The demand for cash is generally because of three behavioral motives:

1) **Transaction Motive** i.e. holding cash for day to day business activities.

2) **Precautionary Motive** i.e. cash needed to deal with unanticipated delays or other uncertainties.

3) **Speculative Motive** i.e. cash needed to take advantage of bargain purchases or availing opportunities out of unexpected developments.

Thus, every organisation not only has to determine the optimum cash balance needed but this cash has to be managed also. Management of cash has the following aspects:

- determining the appropriate cash balance,
- managing of the storage, collection and disbursement of cash balances, and
- investment of temporarily idle cash in interest earning assets.

Very often there are sharp fluctuations in cash requirements. A good financial manager should take appropriate defensive action to handle temporary surpluses or shortages. Some of the steps to be taken in this regard are:

- All cash collections should be deposited in one account, even if there are more than one collection centres. This helps the organisation in storing cash more effectively.
- One should attempt to reduce the timelag between the dispatch of the cheque by the customer and its crediting in the organisation's account.
- There should be constant follow up action for recovery of dues.
- On early payments incentives in the form of discounts can be given.
- 'The disbursement of cash can be withheld till last date.
- ince cash by itself yields no income it should be invested. A suitable criteria should be adopted for this after examining the available alternatives.

Check Your Progress-1

1) What do you understand by financial management?

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2) What aspects would you consider before raising funds?

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3) What steps would you take for managing cash?

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14.5 MANAGING COSTS

The interpretation of the term cost is dependent on the **context** in which it is used along with the nature of the business. For example if you buy a travel guide for **Rs.100/-** its cost to you is **Rs.100/-**. But if the publisher of **this** travel guide has spent **Rs.10/-** on paper, **Rs.5/-** on printing, **Rs.2/-** on royalty to the author, **Re.1/-** for printing, the cost of the **travel** guide for him is **Rs.18/-**. Yet, in simple terms we can say that cost means the amount of expenditure incurred on or attributable to a thing. **Costing refers to the method by which you calculate how much a product or service costs you to produce and sell.** These include two type of costs:

1) **Direct costs:** These are readily identifiable with the produced products and services.

2) **Indirect costs:** These are not readily identifiable but are required in running the business.

Total cost = Direct + Indirect Costs

For example wages paid or raw material procured will be under direct costs. But office and marketing, expenses, etc. are indirect costs. You can ascertain costs only if you have a sound book keeping system like payrolls, invoices etc. Costing helps you in pricing your product or service. You can also ascertain the costly items in the running of your business and plan for cutting them to reduce costs.

There are also **fixed costs** and **variable costs:**

- The costs which do **not change** with the sales or production volume are termed as **fixed costs.** For example, if a tour operator's sales of tour packages does not increase, remains static or goes down, the costs which he is incurring in paying office rent or salaries can not be avoided.
- Such costs which rise or fall in proportion to the sales or production are termed as **variable costs.** For example, if the occupancy rate in a hotel goes down during off season, the management can cut down on the number of room service **personnel** or if the occupancy rate goes up, more personnel can be added to room service.

Let us give you examples of calculating direct and indirect costs.

Direct Costs: Direct costs include direct labour costs and direct material costs. Direct labour cost can be calculated by taking into account the wages and the number of hours actually worked during the year. Suppose you have **five workers** and you give them **Rs.2000/-** p.m. so the total monthly wage Bill = 5 x **Rs.2,000/-** = **Rs.10,000/-.**

The totally yearly wage Bill be 12 months x **Rs.10,000/-** = **Rs.1,20,000/-**

Total number of hours worked during a year by the workers. Say:

52 weeks x 42 hours (per week) x 5 workers – 10,920 hours

Hourly labour costs will be = $\frac{\text{totally yearly wage bill}}{\text{total number of hours worked in a year}} = \frac{1,20,000}{10,920}$ = Rs. 10.9

Suppose for per unit of production, two men are employed and they take five hours for making the same. So the total number of hours used for the production of that unit will be :

Labour time taken x number of workers – total number of hours.

Labour time taken – 5 x 2 = 10 hours

Now the direct labour costs of production for that unit will be:

Total number of hours x hourly labour rate = direct labour costs per unit

i.e. 10 x 10.9 = Rs. 109

Now let us calculate the direct material costs.

The cost of raw material purchased for that unit was Rs.200/-.

The total direct cost for the production of that unit = Total direct labour cost + total direct material cost.

i.e. Rs. 1091- + Rs.200/- = Rs.309/-

Indirect cost

The indirect costs in that production unit included say:

Rent of office	–	Rs.50,000/- per year
Telephone bill per year	–	Rs.15,000/-
Power and electricity	–	Rs.10,000/-
Salary of other office staff per year	–	Rs.40,000/-
Other contingency costs	–	Rs.20,000/-
Total indirect costs	–	Rs.1,35,000/-

The total number of units produced in one year was say 1000.

The indirect cost per unit will be $= \frac{\text{Total indirect cost}}{\text{Total no. of units produced}} = \frac{\text{Rs.1,35,000}}{1{,}000}$

= Rs.135/-

Total cost

The total cost for that unit will be Direct costs + Indirect costs

i.e. Rs. 309/- + Rs. 135/- = Rs. 444/-.

If the manager can introduce efficiency and thus increase the volume of units produced in a year without increasing the indirect costs, the level of profits will go up.

Hence, while managing costs, a manager should be concerned with three aspects:

- Ascertaining the costs,
- Controlling the costs, and
- Reducing the costs.

14.6 BUDGETING

As mentioned earlier, besides raising funds, the other major responsibility of a financial manager is to allocate funds and see to it that they are effectively utilised. The available funds have to be allocated between current and long-term assets and for this investment choices have to be made.

14.6.1 What is a Budget?

A budget is a systematic plan for the utilisation of manpower and material resources. It represents an estimate of future costs and revenues and is quantified in financial terms. In simple words, budgets are written plans of business activity reduced to Rupees or any other monetary term. The main features of a budget are:

- It is prepared in advance 'and is derived from the long-term strategy of the organisation,
- It is related to future plans for which objectives have already been laid down, and
- It is related to a specified period of time.

You may ask the question that what is the purpose of budget. Well a budget helps you in many ways like:

- It clearly states expectations of your organisation and by doing this you can avoid confusion and ambiguity,
- It is a method of communicating the plans and expectations, to everyone in the organisation so that the employees or the departments in an organisation understand, support and implement the policies,
- It helps in maximising the use of organisational resources,
- It helps in reducing wastages and losses,
- It helps in taking timely corrective action and controlling ongoing operations, and
- It serves as a basis for both motivating and evaluating the manager's performance.

The process of budget preparation consist of certain steps like:

1) **Establishing financial objectives** - Generally, the major financial objective for any organisation is long-term profit maximisation. This is true of tourism industry where profits start coming from second or third year only. At the same time, in hospitality and tourism enterprises, certain other objectives are also included while determining the financial objectives of the organisation.

   These include:

   - **providing high quality services,**
   - **to be the lead organisation, *in the area of business,**
   - to be recognised as having the best reputation, or
   - to be the fastest growing organisation.

2) **Forecasting revenues** - For forecasting revenues in the tourism sector enterprises, one should have information regarding the economic environment like economic trends in the tourist generating markets, expected inflation for the budget year, expected variations in the costs of specific purchases, nature of competitive conditions and travel trends etc.

3) **Estimating expenses** - The expenses to be incurred for the budgeted period must be estimated and for this managers must obtain information regarding expected cost increases for supplies and labour costs in order to forecast their variable expenses.

4) **Determining net income** - Generally, revenues minus expenses are equal to net income. Hence in the budget making process, the net income for the budget time period should be determined.

5) **Reviewing and approval** - Once the budget is made, it should be reviewed and approved by the competent authority in the organisation. This could be a Board of Directors, a Budget Committee or an owner manager of a sole-proprietorship business.

14.6.2 Types of Budgets

Every organisation has a master budget i.e. the total comprehensive budget of that organisation. It sets out the plan of operations for all departments for the budget period. Out of this master budget, different types of budgets are prepared for various purposes like sales budget, production budget, purchasing budget, administrative expenses budget etc. Revenues are allocated to meet the estimated expenses of different departments.

Budgets can be classified on the basis'of **Time, Function** and **Flexibility:**

1) In terms of **time,** a budgets can be **long-term, short-term, current** or a **rolling budget**. For example, an organisation may have a long-term budget say for the next ten years, this can be further divided into a short-term yearly budget which can further be sub-divided into a current monthly budget. Whereas some organisations follow a practice of preparing a rolling budget where a budget for a year in advance is always there i.e. immediately after a month or a quarter passes a new budget is prepared for the next 12

months. The figures for the month/quarter which has rolled down are dropped and figures for the next month/quarter are added.

2) In terms of **functions,** the budgets can be classified into sales, production, purchase, research etc. For example, a **sales budget** will take into account the **projected sales** and this is generally the starting point for budgeting. This is because production and inventory levels are generally geared to the rate of sales activity. A **production budget provides estimates of the total volume of production. A** production budget is prepared on the basis of a sales budget and then the **purchasing budget is based on the production budget** because the total materials to be purchased depend on the level of production. Similarly, a **cash budget is a summary statement of your organisation's expected cash inflows and outflows over a particular period of time. It involves projection of future cash receipts and cash disbursements.** It helps the management in determining the future cash needs, planning for financing of those needs and exercising control over cash and liquidity of the firm.

3) In terms of **flexibility,** we have two types of budgets **i.e. fixed budget** and **flexible budget:**

   i) A fixed budget is designed to remain unchanged irrespective of the level of activity and is prepared on the basis of a standard of fixed level of activity.

   ii) A flexible budget is designed to change in accordance with the level of activity attained.

In the case of tourism organisations, a flexible budget is desirable because:

- The nature of business and sales are largely unpredictable,
- It is difficult to foresee the demand in case of new ventures,
- The business is subject to nature variations, for example, a cool summer will affect the travel to hill stations.

14.63 Budgetary Control

The process of the comparison of actual performance with budgeted performance is called budgetary control. This is a crucial activity because every organisation has to evaluate whether. the activities and operations are going in the right direction for achieving the organisational objectives. The actual performance has to be compared with the budgeted performance on the basis of actual level of activity. The actual performance of each area of responsibility is measured through general accounting system in financial terms. Generally, three types of ratios are adopted in this regard :

1) **Activity Ratio** - is a measure of the level of activity achieved over a period of time.

2) **Capacity Ratio** - indicates whether and to what extent budgeted hours of activity ate actually utilised.

3) **Efficiency Ratio** - indicates the degree of efficiency attained in production.

Financial managers also go in for periodical review of budgetary performance and then apply corrective measures to ensure that the future performance is as per the budgets.

There are many other aspects related to financial management and it is suggested that an entrepreneur should utilise the services of a financial consultant. Certain other aspects like balance sheets, profit and loss statements, profitability analysis, project formulation and appraisal etc. have been discussed in Block-5.

Check Your Progress-2

1) Define Direct and Indirect costs?

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2) What is the importance of Budgeting?

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14.7 LET US SUM UP

Financial management is the key to the success of any organisation. This involves a variety of aspects and in this Unit, we have discussed certain issues related to them. Sound financial planning, raising of funds, management of working capital and cash and managing costs form part of this exercise. You have also been familiarised with the importance of budgeting and the types of budgets in this Unit. The issues mentioned in this Unit are common to all organisations whether small or big. But our emphasis has been on equipping you with financial knowledge in case you intend to start your own small business. As the organisations grow, the level of financial activity also increases. For example, in a big organisation with a number of shareholders, the financial activity will include decisions related to payment of dividends, raising capital through floating new shares or right's issues. etc. For managing the financial resources efficiently and effectively, the financial managers have to look for constant flow of economic information and have to use their skills to interpret this information for financial decision making.

14.8 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress-1

1) Base your answer on the definition given in Sec.14.2.

2) In Sec.14.4, we have mentioned the questions that should be raised for sound financial planning while raising funds, like the rates of borrowing, repayment capacity etc.

3) See Sub-sec. 14.4.2 for your answer.

Check Your Progress-2

1) See the definitions given in Sec.14.5.

2) Read Sub-sec.14.6.1 for your answer.