

Ideally there should be no shortage of working funds, but, some shortage on working capital is always good. That makes all the managers of the company run harder, and forces them to introduce economics. Many a times, in many successful units, artificial shortage of working capital is created. But then these are planned, and not forced, shortages.

Points to Ponder

1. Many a times a profit earning company also faces working capital shortages. Why?
2. Please study the impact of
 - a. better technology, and
 - b. pricing policy on working capital.
3. Can shortage of working capital always be solved by pumping in additional funds?
4. What is a sick unit? Why do units go sick? What are the remedies?

p 111-113

ANALYSIS OF FINANCIAL STATEMENTS

We have, in the earlier chapters, tried to understand how accounts are to be maintained.

The output of the whole exercise, as we saw, are the profit & loss account and balance-sheet. Added thereto are the Auditor's report and the Directors' report which finally makes the '*Annual Report*'.

The end-users receive these annual reports, as an official document from the company. Various end-users, i.e., Shareholders, Investors, Bankers, Government Departments, etc. use them as guidelines while taking decisions.

How would one look at these annual reports?

Naturally, the reader will have his own reasons for reading it (perhaps just to find out how much salary does Mr. X draw from the company!). For the purpose of Financial Analysis, Various Tools and Techniques have been developed to analyse these Financial Statements. Two of the most commonly used techniques are:

- A. Ratio Analysis.
- B. Fund Flow Analysis.

A. RATIO ANALYSIS

A '*Ratio*' is an expression of a relationship between two numbers . It can be expressed as a percentage or as a proportion or as a relation.

Theoretically, therefore, a ratio can be worked out between any two numbers. So one has to select the numbers, whose relationship would carry some meaning, would throw some light on the financial bearings of the company. Some such numbers (ratios) are given below:

TO ASSESS

RATIO

- 1. Stability
 - 1. Fixed Assets (Equity Shares + Preference Shares + Reserves + Surplus) (Called Fixed Assets: Net Worth Ratio)
 - 2. Short Term Liabilities + Long Term Liabilities (including all debentures & Bank Finance/Net Worth) (Called Debt: Equity Ratio)
- 2. Liquidity
 - 1. Current Assets/Current Liabilities (called Current Ratio)
(N.B.: Current Liabilities normally includes working capital financed by bank)
 - 2. Current Assets: Inventory/current Liabilities (Excluding Bank finance) (called Quick Ratio or Acid Test Ratio)
- 3. Rotation of Finance
 - 1. Cost of Sales/Average Sales (called Stock Turnover Ratio)
 - 2. Debtors x 365/Annual Credit Sales. (called Debtors Turnover Ratio)
(N.B.: Debtors include bills receivables)
 - 3. Creditors x 365/annual Credit Sales (Called Creditors Turnover Ratio)
(N.B.: Creditors include Bills Payable)
- 4. Profitability
 - 1. Gross Profit X 100/Sales (called GP ratio)
 - 2. Net Profit X 100/Sales (called NP ratio)
 - 3. Profit Before Interest & Tax/Net Worth + Borrowed Funds. (called

Return on Total Capital Employed Ratio or Return on Investment)

- 5. Coverage of Obligations
 - 1. Profit before Interest & Tax/ Interest Expenses. (called Interest Cover)
 - 2. Profit After Interest, Tax & Preference Dividend/Equity Dividends. (called Dividend Cover)
 - 3. NP Before Taxes (annual/Annual Loan Installments)
- 6. Management of
 - 1. Stock of Finished goods/Cost of Working Capital Goods Sold
 - 2. Stock of Raw Material X 365/Raw Material Consumed
 - 3. Debtors/Sales
 - 4. Creditors/Purchases
- 7. Earnings
 - 1. NP After Tax and Preference Dividend/No. of Equity Shares (called Earnings Per Ratio-EPS)
 - 2. Average Market Price Per Share/ Earnings Per Share. (called Price Earning Ratio - Cr PE ratio)
 - 3. Dividend Per Share/Earning Per Share (called Dividend Payout Ratio)
 - 4. Average Net worth Preference Capital/Number of Equity Shares. (called Book Value Per Share)

The list of ratios can be extended. It entirely depends upon what one wants to know.

However, working out the ratios only for one year will not always help. In order to know the trend, one should work out ratios for more than one year. At times, it is also useful to compare these ratios with those of other comparable units, in order to get a picture of comparative performance.

A question that arises is: how do we find out whether a particular ratio is 'Good' or 'Bad'? The answer depends upon the type and style of industry, upon various factors affecting its performance and also upon the purpose of the study. Therefore, it is virtually impossible to set precise "standards" for the ratios. Interpretation of these ratios becomes an area of skill and ceases to be a mere number game.

B. FUNDS FLOW STATEMENT

Like ratios, the *Funds Flow Statement* is also a tool of Financial Analysis. With this tool, valuable information can be obtained from the financial statements regarding the *Financial Policies*.

It will be easier to understand the concept of funds flow if we picture the streams of funds flowing in and out of a unit. Exhibit-1 shows the funds movement. Since funds originate from somewhere (*source*) and are used somewhere (*application*), the funds flow statement is also known as the '*Source and Uses of Funds Statement*'. Many companies now give a '*Source and Applications of Funds Statement*' together with the Balance Sheet and Profit And Loss Account. It is also called *Cashflow* in common parlance.

For calculating a fund flow statement, the Balance Sheet figures are taken as on two dates, not necessarily successive years, though it is most usual to do so. Then under each head of Asset and Liability the difference that has taken place between the two dates is arrived at. The first step in constructing a statement is to decide whether a particular item of difference constitutes an expenditure (use) of funds or the origin (source) of funds.

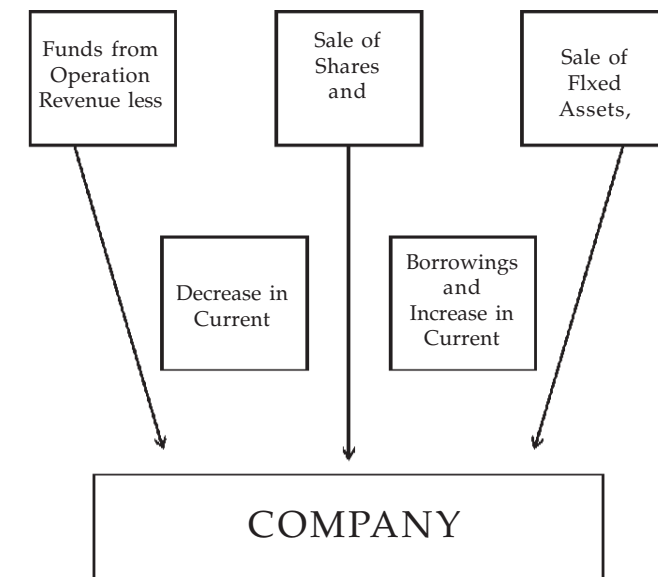
Following are the Guiding Rules for deciding this:

1. An increase in assets is a use of funds, a decrease in assets is a source of funds.
2. A decrease in liabilities is a use of funds, an increase in liabilities is a source of funds.

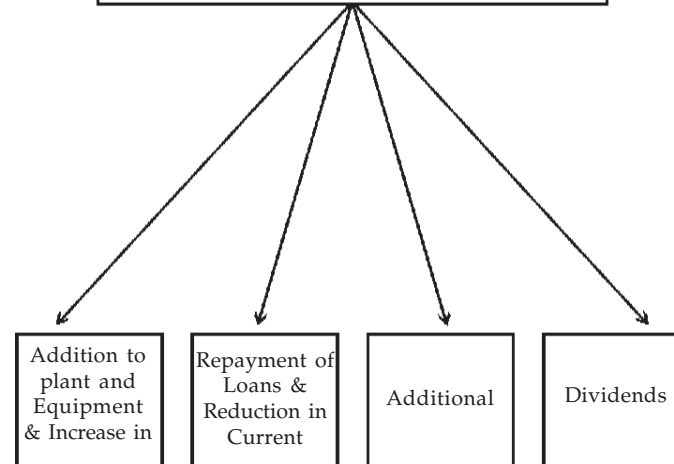
While application of these rules will cover most of the items in the Balance-Sheet, one item which will be taken as a source is the net operating profit. Since depreciation is a mere book entry not involving any cash outflow, the operating profit is taken without reducing the charge of depreciation or similar write-offs. Please note that Net Operating Loss will be a use of funds.

EXHIBIT: FLOW OF FUNDS

INFLOWS



OUTFLOWS



Once we have classified the sources and uses of funds, one has to merely to put them in the form of a statement where the totals of both sources and uses of fund will be equal.

Use of the Fund Flow Statement: A funds flow statement can be useful in several ways:

1. The statement can be used to analyse what has happened in the past, how funds have been collected and how they have been used. For this reason, it is a statement of sources and uses of funds. It will provide an Insight into the Financial Policies pursued by the company, particularly, for financing fixed assets. It will give us an idea about the funds secured from outside, funds generated from within the company, change in the debt-equity mix, etc.
2. The statement provides a useful information about the Use of Funds. Many a times management wonders why, in spite of good profit, the company has pressures on liquidity. The most common reasons are either a rise in inventory or raw materials or a rise in book debts. Such things are brought to light by a funds flow statement.
3. A funds flow statement can also help in Future Planning. A projected funds flow statement is an essential device for planning the timing and character of project financing. For this, estimates of funds for New Assets, Working Capital, Dividends and Repayment of Debts are made.

Estimates are made for the funds to be provided by operations and the difference, if positive, represents the funds that must be obtained by borrowing or by issuing new securities. If the indicated amount of new funds required is greater than management thinks it is feasible to raise, it must review the position. *For example*, it can re-examine its plans for acquisition of new assets and dividend policies so as to bring the planned uses of funds in line with the sources.

A NOTE OF CAUTION ON RATIOS AND FUNDS FLOW

The funds flow statement and ratio analysis do provide a reader with a lot of relevant data. They also give an impression of precision and absolute reliability. But there lies a danger. One has to understand the Basic Assumptions underlying these Financial Analysis.

The ratios and the funds flow statements of past years are prepared based upon annual accounts prepared on the generally accepted accounting principles, concepts and, conventions. This itself leads to Certain Limitations:

- a. The assets are reflected on historical cost of acquisitions. Fixed assets particularly reflect a much lesser value than their actual market value.
- b. Transactions which do not have monetary value (e.g., goodwill built-up, image, expertise, manpower) do not find a place, in these statements.
- c. Different Approaches of recognizing revenue and of matching expenses with revenue can be taken by different firms or valuers. This would make results of two firms and of the same firm from year to year less comparable.

For example, one firm might value all finished goods stock at full cost or market price, whichever is lower. Another firm might value it at manufacturing cost or market price, whichever is lower. Some firms might follow the written down value method of depreciation and others would follow the straight-line method.
- d. It is also alleged that companies resort to “Window-Dressing”, which makes the financial statements less reliable. Window-dressings include selling the company’s goods at a much higher price to associate concerns, repaying certain liabilities on the very last day and again taking back the loan on the next day, and so on.
- e. There is again a growing trend not to provide for certain liabilities in the books, but to explain it away by way of notes to the Balance Sheet, e.g., not providing for excise duty levied by the government against which a suit is pending.

A good reader therefore, should not only read the figures, but should also note the notes!
- f. Financial statements give only data about the past. The focus on future is completely missing whereas the readers’ decision is going to have an impact on the future.

These statements, therefore, merely provide a guideline. An intelligent reader, nonetheless, should not get scared of these limitations. He can take them in his stride. These limitations do not, in any case, make the tools useless. They just add a *Pinch of Salt* to an otherwise obvious conclusion.

BUDGETARY CONTROL

NEED FOR PLANNING

Everyone makes plans. A group of people who do not act with respect to some plans exhibit characteristics of an incoherent, purposeless crowd. They do not constitute an organization in the correct sense of the term.

Different people plan differently. Some plan in their minds, others roughly on bits and pieces of paper, and still others in an orderly and systematic fashion. The term budgeting refers to the last process.

Commercial Organizations have added various dimensions to the forms of budgeting. They have moved away from expenditure budgeting to budgets encompassing the totality of the operations. They prepare cash flow budget, profit and loss budget and also have budgeted Balance Sheet. The Physical Indicators of Performance are also budgeted e.g. Capacity Utilization.

Advantages of Budgeting

Budgeting is advantageous to management in various ways. Its functions and purposes can be summarized as follows:

1. Budgeting Integrates various activities handled by a variety of people in the organization and studies their combined effect on the profits.
2. It helps to Identify the areas where Further Action is needed.
3. It creates Better Understanding and Communication amongst the people.
4. It helps to draw out profit plans and to Rationally Allocate Resources.
5. It necessitates specification of Objectives, setting up Yardsticks to measure their achievements and consideration of Alternate Plans to allocate resources on a rational basis.