CHAPTER-1

Conceptual Framework of Liquidity Management

<table>
<thead>
<tr>
<th>Particular</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concept of Liquidity</td>
<td>2</td>
</tr>
<tr>
<td>Concept of Liquidity Management</td>
<td>2</td>
</tr>
<tr>
<td>Meaning of Liquidity Management</td>
<td>4</td>
</tr>
<tr>
<td>Need an Importance of Liquidity Management</td>
<td>5</td>
</tr>
<tr>
<td>The operating cycle consists of three phases</td>
<td>6</td>
</tr>
<tr>
<td>Principles of Liquidity Management</td>
<td>8</td>
</tr>
<tr>
<td>Technique of Liquidity Management</td>
<td>11</td>
</tr>
<tr>
<td>Relationship between Liquidity and Profitability</td>
<td>14</td>
</tr>
<tr>
<td>Significance of a Study for Stakeholders</td>
<td>14</td>
</tr>
<tr>
<td>Evaluation Methods</td>
<td>15</td>
</tr>
<tr>
<td>References</td>
<td>23</td>
</tr>
</tbody>
</table>
**CONCEPT OF LIQUIDITY:**

Finance is a like blood in our body so long as blood-circulate properly in the body; we feel healthy and have capacity to work. If circulation is not proper, it will put effect on the functioning of the body, similarly it will be difficult for business concern to take financial decision related to the determination of the amount of long-term finance required and the sources from which such finance is to be raised. The optimum capital structure should be determined by keeping in mind the long-term and short-term requirement of finance.

No doubt the investment decision is very much important from the long-term point of view aid in the changing spectrum of business. A business organization has to face quite often the problem of capital investment decision, because investment in this project has quite heavy and have to be made immediately, but the returned will be available in the long run. For replacement expansion diversification, research and development investment decision are most crucial and critical, but the availability of short-term fund in most in liquid form is also very important. The small, but very important short-term transactions need availability of sufficient liquid resources. Short-term solvency much depends upon the availability of liquid resources as per short-term availability as short-term requirements. No businessman can aspire to keep surplus fund in the business but while developing these surplus funds he has to estimate its short-term requirements. Liquidity effects over short-term capacity to pay day to day say routine transaction.

Thus, we say that businessmen want to hold imbalance a sufficient quantity of liquid assets. So that undue solvency risks are not imposed on it. This is a logical approach indicating quantitative amount of liquid resources. Thus, the modern business atmosphere financial experts have to consider a minimum amount of liquid capacity in the business apprises management in estimating property that prospects needs. Insufficient liquid resources may cost a black shadow on goodwill of the concern because the ability to pay short-term liability may be doubted by the external parties. Thus the concept of liquidity comes in the light of proper financial functioning to the business.

**CONCEPT OF LIQUIDITY MANAGEMENT:**

"In the management of liquidity two characteristics of current assets must be boom in mind:

1. Short life span and,
2. Swift transformation into other assets forms."
1. Short life Span

Current assets have a short life span, cash balance may be hold idle for a week or account receivable may have a life span of 30 to 60 days and inventories may be held for 30 days to 100 days. The short life span of current assets depends upon the requirement of firm, in the activities of procurement production sales collection and the degree of synchronization among them.

2. Swift transformation into Other Assets Forms

Each current asset (C.A) had swiftly transformed into other assets forms. Cash is used for acquiring raw materials. Raw materials (R.M) are transformed into finished goods (this transformation may involve several stage of work in progress) Finished goods generally sold on credit are converted into account receivable (book debts); and finally, Account receivable on realization generated cash.

Figure 1.1 is show the cycle of transformation -

Conversion of operating cycle

Cash

Raw Materials

Work-in-Progress

Debtors

Sales

Finished Goods

The short life span of working capital components and their swift transformation form one into another as certain implementations: -

(1) Decisions relating to working capital management are repetitive and frequent.

(2) The difference between profit and present value is in significant.

(3) The close interaction among working capital components implies that efficient management of one component can not be under taking without simultaneous consideration of other components that is if the firm has a large accumulation of finished goods inventory. It may have to provide more liberal credit terms.
or show laxity in credit collection. Another example if they have a cash crunch it may have to offer generous discounts.

The investment of net current assets could not reveal the capacity to pay very short-term obligation. Investment in these assets may seem to be sufficient but the composition of current asset may say a different story. Suppose a business concern has working assets of Rs. 5 laces and its current liabilities are Rs. 1 Lacs. Then the concern may be said solvent keeping in view the investment in short-term assets. But if the value of stock in these assets is Rs. 450 thousands then the situation here reverses the concept of liquidity developed. It is correct that stock may be converted into cash (the most liquid form of the asset). But how much time it will take, we cannot say that in this case payment of short-term obligation may be difficult. Hence, the idea developed that sufficient of cash and bank balance plus other liquid assets should be kept as minimum. So that businessman discharges its short-term commitment due to this reason the concept of liquidity developed. It indicates what portion of current assets in the form of liquid assets.

**MEANING OF LIQUIDITY MANAGEMENT:**

The term 'Liquidity' means the ability of an organization to realize value in money the post liquid among all assets. It implies conversion of assets into cash during the normal course of business and to have regular uninterrupted flow of cash to need outside current liabilities as and when due and payable and also ensure availability of money for day-to-day business operations. The concept of liquidity in case of companies has two dimensions viz; the quantitative and qualitative. The quantitative aspect includes the quantum, structure and utilization of liquid assets. The qualitative aspect emphasizes upon the ability of a firm to need all present and potential demand on cash in a manner that minimize cost and maximize the value of the business.

The liquidity is a vital factor in business operations. For the very survival of business, the firm should have requisite degree of liquidity. It should be neither excessive nor inadequate. Excessive liquidity means accumulation of ideal funds. Which may lead to lower profitability, increase speculation, and unjustified extension, extension of liberal credit terms, liberal dividend policy etc; whereas inadequate liquidity result in interruptions of business operations. A proper balance between these two extreme situations therefore should be maintained for efficient operation of business through skill full liquidity management. The need of efficient liquidity management corporate sector has become greater in recent years.
NEED AND IMPORTANCE OF LIQUIDITY MANAGEMENT:

The need for liquidity of current assets could not be over emphasized. The efficient management of liquidity is an integrated part of overall finance management and has a bearing on the objective of the consolidation of short-terms solvency position to achieve this. It is necessary to generate sufficient liquid fund. The extent to which liquidity can be gained will naturally depend upon the magnitude of the sales. The efficiency of collection department, the lowest period of operating cycle etc. a successful collection programmer is in other words, necessary for maintaining liquidity by any business enterprises. Those sales don't convert into cash is instantly remain a time lag between the sales of goods and receipt of cash.

There is therefore a need for liquidity in the form of cash and bank balance, marketable security and bills receivables etc. will deals with the problem arising out of take of immediately realization of current assets? Therefore sufficient liquidity is necessary to certain the ability to pay short-term obligations. Technically, liquidity depends upon the production or cash cycling. The operating cycle can be said to be; the heart of the need for liquidity. "The continuing flow from cash to supplier to inventory to account receivable and back into cash what is collected operating cycle." In other words, the terms cash cycle refused to the length of time necessary cycle events:

1. Conversion of cash into inventory.
2. Conversion of inventory into receivable.
3. Conversion of receivable into cash.

Thus, the operating cycle is a continuous process. If it were possible to complete the sequences instantaneously, there would no need of liquid fund. But since it is not possible; the firm is forced to have current assets. Since cash inflows and cash outflow don't match, firms have to necessity keep cash or investment in short-term liquid securities.

Therefore they will be in a position to meet due obligation as per requirement. Similarly, business concern must have adequate Inventory to guard against the possibility of not being able to meet a demand for their products. Adequate inventory therefore provides a cushion against being out of stock. If the firms have to be competitive they must sale goods to their customers on credit which receivables the holding of account receivable. It is in these ways that an adequate level of working capital is absolutely necessary for smooth sales activity which, in turn, enhances the liquid position of the concerns.
THE OPERATING CYCLE CONSISTS OF THREE PHASES:

1. Cash Gets Converted into Inventory

   This would include purchase of raw materials, conversion of raw materials into work-in-progress, finished goods and terminate in the transformation of goods into stock at the end of the manufacturing process. In the case of trading organizations, this phase would be shorter as there would be no manufacturing activity and cash will be converted into stock directly. The phases will, of course, be totally absent in the case of service organization.

2. Conversion of Inventory into Receivable

   In the second phase, the inventory is converted into receivables as credit sales are made to customers. Firms, which do not sell on credit, will obliviously do not consist of second phase of the operating cycle.

3. Conversion of Receivable into Cash

   The last phase thirds represent the stage when receivables are collected, this phase complete the operating cycle. Thus, the firm has involved from cash to inventory, to receivables and to cash again. Thus the process of gaining liquidity is of vital importance. The need and importance of liquidity management is due to the followings points:

   (A) Management of Short-term Solvency

   Liquidity or availability of liquid resources gives an indication of the capacity to pay its short-term obligation. This kind of information is valuable for short-term creditors and present and future investors.

   (B) Management of the Efficiency of the Credit Department

   In the normal course of the business no firm can strict to cash sales only. Every business concern has to sale on credit if the collection for debtors is very slow than it will affect the quantum of liquid resources. The concern may feel difficulty in paying short-term liabilities. Thus it is very necessary to know the efficiency of collection department and sufficient amount of collection will be hence the liquidity of the concern.

   (C) Inter-Firm Comparison

   As regard the liquidity we can compare the position of different firms, in case of paying its short-term liabilities. Thus on the basis of liquidity inter firm comparison may also be done.
(D) Early Payment to Suppliers
Sufficient liquidity will enable the business to its suppliers immediately. Similarly, the concern may not feel difficulty in acquiring raw materials regularly and consequently the production activity may be continued without any obstruction.

(E) Benefits of Cash Discount
If we have sufficient liquidity we can get the benefit of cash discount on goods purchase by doing this, the production cost will be decreased and in that case business firm may reduce its prices and will be able to compete better.

(F) Payment of Dividend
Due to lack of liquidity, sometimes it happens that business activity is going very smoothly but the concern is not able to pay dividend. This situation arises when the quantum of credit sales is very high consequently. The business concern is not able to pay dividend while the profit and loss account show the sufficient profits but if it have sufficient profit and liquidity, we may pay attractive dividend and the shareholders may get full satisfaction and the prices of the security will also remain static.

(G) Increase in Credit and Capacity of Getting Loans
The institutions, which have sufficient liquid resources, may be treated as institution of having good financial position. This type of institution may get loan and advances where needed. Secondly, the institution may be able to run it's manufacturing and trading activity continuously without any difficulty.

(H) Easy Bank Loan
If the concern has sufficient liquid asset, the short-term solvency may be treated as good and banks will hesitate to give short-term or long-term loans. Because, the sample of liquid assets over liquid liabilities it treated as a good security by the bank.

(I) To Make Use of Favorable Conditions
If business conditions have a tendency to change and have sufficient liquidity, it can make use of favorable condition and may gain profit. I.e. if there is a probability of price rise in raw materials we can purchase sufficient amount of raw materials. Thus, we can make use of this favorable condition provided that we have sufficient liquid resources.

Sufficient liquid resources will effect psychologically to directors and managers and they will be more inspired to work with zeal. Similarly, if the employees get their salary with allowances in time, they will work more effectively. Thus, sufficient liquid resources physiologically, motivate managers as well as employees and by this the efficiency of the concern will increase.
(J) Helpful in Payment of Contingencies
In case of contingent events and contingent trading difficulties we can face them easily, if we have sufficient liquid resources.

(K) Increase in Efficiency
Sufficient liquid resources will effect psychologically to directors and managers and they will be more inspired to work with zeal. Similarly, if the employees get their salary with allowances in time, they will work more effectively. Thus, sufficient liquid resources physiologically, motivate managers as well as employees and by this the efficiency of the concern will increase.

(L) Increase in Productivity of Fixed Assets
Sufficient liquid resources increase the productivity of fixed assets that is, if raw materials and labour is available in sufficient quantity the machine will work on full capacity without liquidity. Fixed assets will be age arises without ammunition. Proper management of liquidity is very important for the success of an enterprise. The manner of management of liquidity to very large extent determines the successes of the operation of concern. Constant management is required to maintain appropriate levels in the various working capital accounts. The failure of any enterprise is undoubtedly due to poor management and absence of management skill, shortage of liquidity, so often advanced as the main cause of failure is nothing but the clearest evidence of poor management which is so common. There are many aspects of liquidity which make it an important function of the financial manger, on the one hand it maintain proper liquidity, while on the other it help in increasing the profitability of the concern.

PRINCIPLE OF LIQUIDITY MANAGEMENT :
The liquid Capital needs of a firm are influence by numerous factors. The important principles of liquid capital are as under: -

(1) Nature of Business
The amount of liquidity required by a firm depends largely on the nature of business. In rail components Transports Company, electronic company and many other welfare institution of very less amount of liquidity is required because amount of liquidity depend on cash receipt and sales of service in cash. Contrary to this business firm organized in the productive of luxury items need a large amount of liquid capital, because due to fluctuation in demand, they need a higher quantity of stock.
(2) Seasonality of Business
Due to seasonal business fluctuations, demand of these products may vary. They have products available in particular seasons. The amount of liquidity had also fluctuated according to the seasonal requirements. Some industries are such in which the demand of these products remains throughout the year, but the production will be done in a particular season as sugar industry, woolen industry, and cola industries in India. In those types of industries, a large amount of liquidity is required in the productive season.

(3) Production Policies
No business concern can fully rely on cash sales. It has to sell on credit. If the credit period is less and collection department is efficient than more liquid resources are required. If the collection period is long, then a high amount of liquid capital is required. Thus, the ordering policy of a concern dictates the amount of liquid capital.

(4) Size of Business
The size of business is an important factor in determining the amount of liquid capital. A large-scale production industry needs a large amount of liquid capital in comparison to productive institutions of small size.

(5) Period of Operating Cycle
The business concern having a large gestation proportion period needs a large amount of liquid capital, because their periodical operating cycle is of a greater period. While industry having a shorter operating cycle need a lesser amount of liquidity. In the first case, the concern has to keep a larger amount of capital in liquid form to pay current liabilities. Thus, the amounts of liquidity depend upon the period of operating cycle.

(6) Proportion of Raw Material in Cost
The concern having a large proportion of raw materials in its production need higher liquidity, because, the concerns have to pay higher amounts of purchases of raw materials in seasonal business. The concern needs higher stock of raw materials and in that case they need higher amounts of liquidity.

(7) Credit Availability and Purchasing Time
The condition relating to credit decided by the creditors affects the amount of working capital. The business concern in which easy credit is available, lesser amount of working capital is required. Similarly, if we have liberal credit facilities from the bank, we may run business with a small working capital.
Secondly, the time of purchasing also decides the amount of working capital. If the total raw materials is purchased at the beginning that is on the time of new crops coming in the market. We require a higher amount of liquid capital in that month in the next month that is maximum amount of liquid capital requirements

(8) Fluctuation of Business Activities
If the business activity fluctuates, a higher amount of liquid capital is required. In the boom period, the demand condition increases together with the increase in prices. In this situation, the business concern requires sufficient inventory of raw materials. Contrary to this during the depuration business activities become sluggish and a lesser amount of liquid capital to be sufficient.

(9) Growth Rate of Business
The growth in existing business and the tendency of expansion directly affected the amount of liquid capital. If the growth rate and expansion is low, lower amount of working of capital may be sufficient but if the expansion is done at a higher rate than larger amount of fund is needed for fixed assets as well as for current assets.

(10) Amount of Profit and Dividend Policy
Ploughed back of profit is an important source of working capital provided that profit is earned in cash. Therefore, in the concerns in which profit-earning capacity is due to good production and marketable securities management and monopoly, they need a lesser amount of liquid capital. On the other hands, if the profit earning capacity is low, higher amount of working capital is required.

(11) Other Resources
Beside the above factor various other points are responsible for the amount of liquid capital: -

(a) Role of industrial development;
(b) Means of transport and communication;
(c) Political stability;
(d) Market condition; and,
(e) Condition of supplies etc.
TECHNIQUE OF LIQUIDITY MANAGEMENT:

There are some specific techniques of liquidity management and process for speedy collection of receivable from customers and slowing disbursement. We discuss in the present section.

(1) Speedy Cash Collection

In managing cash efficiency, the cash inflow process can be accelerated through systematic Planning and refined techniques. There are two broad approaches to do this. In the first place, the customers should be encouraged to pay as quickly as possible. Secondly, the payment from customers should be converted into cash without any delay.

(2) Rapid Payment by Customer

One way to ensure rapid payment by customers is prompt billing. What the customer has to pay, the period of payment, etc., should be notified accurately and in advance. The use of mechanical devices for billing along with the enclosure of a self-addressed return envelope will speed-up payment by customer. Another, and more important, technique to encourage prompt payment by customers is the practice of offering trade discount. The availability of discount, as discussed earlier, implies considerable saving to the customers. In their anxiety to avail of the facilities, the customers would be eager to make payment early.

(3) Early Conversion of Payment in Cash

Once the customer makes the payment by writing a cheque in favor of the business concern, the collection will be expedited by prompt encashment of the cheque. It can be recalled that there is a long lag between the time a cheque is prepaid and mailed by the customer and the funds are included in the cash reservoir of the companies.

The early conversion of payment into cash, as a technique to speed-up collection of accounts receivable, is done to reduce the time lag between posting of the cheque by the customer and the realization of money by the concerns. The postal float, lethargy and bank float are collectively referred to as deposit float. "The term deposit float is defined as the sum of cheques written by customers that are not yet usable by the firm." The collection of accounts receivable can be considerably accelerated, by reducing transit, processing and collection time. An important the cash management technique is reduction in deposit float.

(4) Concentration Banking

In this system of decentralized collection of accounts receivables, large companies, which have a large number of branches at different place, select some of these, which are strategically located as collection centers for receiving payment from customers. Under this
arrangement, the customers are required to send their payments to the collection center covering the area in which they live and these are deposited in the local amount of the concerned collection center, after meeting local expenses. "A concentration bank is one with which the firm has a major account usually a disbursement account." Concentration banking is a system of decentralized billing and multiple collection points is a useful technique to expedite the collection of account receivables. It reduces the time needed in the collection process by reducing the mailing time.

"The mailing time is saved both in respect of sending the bill to the customers has as well as in the receipt of payment. Another advantage is that concentration permits the firm to 'store' its cash more efficiently."

(5) Lock-Box System

The lock-box system is like concentration banking in that the collection is decentralized and is done at branch level. But they differ in one very important respect. While the customer sends the cheque, under the concentration banking arrangement, to the collection centers, he sends them to a post office box under the lock-box system. The lock-box system is an important is the concentration baking system. In other words, the processing time with in the firm before depositing a cheque in the bank is eliminated.

The use of concentration banking and lock-box system accelerates the collection of receivables it in involves a cost. While in the case of the former, the cost is in terms of the maintenance of multiple collection centers compensation to the bank for services represent the cost associated with the latter. Thus, the lock-box system, as a method of collection of receivables, has a two-fold advantage: (i) the bank performs the clerical task of handling the remittances prior to deposits, services which the bank may be able to perform at a lower cost; (ii) the process of collection through the banking system begins immediately upon the receipt of the cheque / remittance and does not have to wait until the firm completes its processing for internal accounting purposes."

(6) Slowing Disbursement

Apart from speedy collection of accounts receivable, the operating cash requirement can be reduced by slow disbursements of Accounts payable. It may be recalled that a basic strategy of cash management is to delay payment as long as possible without impairing the credit rating / standing of the firm. In fact, slow disbursements represent a source of funds requiring no interest payments. There are several techniques to delay payment of accounts
payable, namely; (A) Avoidance of early payments; (B) Centralized disbursement; (C) float; and, (D) Accruals.

(A) Avoidance of Early Payments

One ways to delay payments is to avoid early payments. According to the terms of credit, a firm is required to make a payment within a stipulated period. It entitles a firm to cash discounts. If, however, payments are delayed beyond the due date, the credit standing may be adversely affected so that the firms would find it difficult to secure trade credit later. Thus, a firm would be advised might not payment early i.e. before the due date.

(B) Centralized Disbursements

Another method to slow down disbursement is to have centralized disbursement. The head office should make all the payments from a centralized disbursement account. Such an arrangement would enable a firm to delay payments and conserve cash for several reasons. Firstly, it involves increase in transit time. Secondly, the reason for reduction in operating cash requirement is that since the firm has a centralized bank account, a relatively smaller total cash balance will be needed.

(C) Float

A very important technique of slow disbursement is float. The term float refers to the amount of money tied up in cheques that have been written, but have yet to be collected and encased. Alternatively, float represents the difference between the bank balance and bank balance of cash of a firm. The difference between the as shown by the concern record and the actual bank balance is due to transit and processing delays. There are three ways of float are as below:

(a) Paying from a distant bank.
(b) Cheque-encashment analysis and,
(c) Bank draft.

(D) Accruals

The potential tool for stretching accounts payable is accrual which is defined as current liabilities that represent a services or goods received by a concern but not yet paid for. The longer the period after which payments IS made, the greater the amount of free financing and the smaller the amount of cash balance required.
RELATIONSHIP BETWEEN LIQUIDITY AND PROFITIBILITY:

Liquidity has an important relationship with profitability. If we have enough liquid resources, we may be able to get benefit of cash discount on purchases and consequently that will be result in increasing profits. If we cannot pay the creditors for goods in the given period, we have to pay interest on the amount of purchases. Thus, shortage of liquid resources will result in low of cash discount and payment of interest. Both the losses will certainly decrease over profits. Secondly, we may keep the stock at desired manners and that will benefit us in circulation of business activities. Contrary to this, if we are not able to keep sufficient stock due to shortage of liquid resources, then the production cycle may not be continued and that will result in heavy losses.

Liquid resources of a business concern for all over to expand huge business activities more, and less in financial. In case of steel industry in India, the management of liquid resources plays a greater role because in comparison to others industries, this industry has capacity to pay its obligations promptly.

SIGNIFICANCE OF A STUDY FOR STAKEHOLDERS:

The above study is made for the point of all live participants who are interested in the routine of the business organization. Those are as under.

(1) Management Point of View:

The above study plays vital role in providing such information to the management, which needs for planning decision-making and control e.g. operational efficiency analysis provides gross profit, operating expenses analysis and profit margin. Asset management outlines asset turnover, working capital under inventory turnover, accounts receivable and payable profitability position shows return on assets, earning before interest and taxes (EBIT), and return on assets. Gesternberg stated that “management can measure the effectiveness of its own policies and decisions, determine the advisability of adopting new policies and procedures and documents to owners as result of their management efforts”8

(2) Important to Investor:

According to Erich A.Helfert “Importance of performance lies for owners/potential investors should know easily. The financial position of the company by return on net worth, return on common equity, Earnings per share, Cash flow per share, Dividend yield, dividend coverage, Price earning ratio, market to book value, Pay out/retention”9. The potential investors of the business organization in turn are interested in the current features.
(3) Creditors Point of View:

Creditors doing business with company simply study its performance by current ratio, acid test ratio, and debt to assets, equity and capitalization, interest coverage and principal coverage before lending the finance. The study of these describes real features of business organization to the creditors.

(4) Government Point of View:

Government has significance to study liquidity productivity and financial efficiency of an individual organization or industry as a whole, various. Taxes, revenues, financial assistance, sanctioning, subsidy, to a business organization or industry as well as price fixing policies, frame outlines the key role of study for the Government lies in planning, decision making and control process.

(5) Employees and Trade Unions Point of View:

Employees are resources of the company and are interested to know the financial position and profit of the company. Generally they analyze by the comparison between past and present performance, profit margin and cash flow of the company. Trade unions are interested to know the data of financial performance pertaining to their demands for increase in wages, salaries, facilities, and social welfare.

(6) Society and Others:

Society and others are including in external environment of the company and every business organization has a greater responsibility towards society.

In this context performance should be studied through various types of social elements such as customers investors, media, credit institutions, labour bureaus, taxation authorities, economists are interested for the study of a business organisation while society as whole also looks forward to know about the social contribution, i.e., environmental obligations, social welfare etc.

EVALUATION METHODS:

A study of liquidity, productivity and financial efficiency through profitability is made by using the following tools and techniques.
[1] Ratio Analysis:

Ratios analysis is the process of determining and presenting in arithmetical terms the relationships figures and groups of figures drawn from these statements. A ratio expresses the results on the basis of comparison of two figures in numerical terms.

A ratio is a statistical yardstick that provides a measure of relationship between two accounting figures. According to Batty “Accounting ratios describe the significant relationship which exists between figures shows on a balance sheet in a profit and loss account in a budgetary control system or in any other part of accounting organization.” 10. The ratio is customarily expressed in following ways:

1. It may be obtained by dividing one value by other. This expression is known as “Times”
2. If hundred then the unit of multiply the above expression becomes percentage.
3. It may be expressed in the form of “proportion” between the two figures or known as pure ratio.
4. It may also be depicted in the form of graphs like ratio graph.

Importance:

A ratio is known as symptom like blood pressure. The pulse rate of the temperature of an individual often ratio analysis is used as a devices to diagnose the financial position of an entreprise. It shall point out if the financial condition is very strong, good, partly good, and poor. As such the ratio analysis is a powerful tool of financial analysis through it economic and financial position of a business unit can be fully x-rayed.

Ratio analysis becomes meaningful to judge the financial condition and profitability. Performance of a firm only when there is comparison of present in fact analysis involves two types of comparison. First a comparison of present ratio with past and expected future ratios for the same firm, the second method of comparison involves comparing the ratio of the firm with those of similar firms of with industry average at the same point of time.

Further “Ratio analysis” presents the figures in which the net result of the financial position and problems is concentrated. They provide a co-ordinate frame of reference for the financial manage. They tell the entire story of the ‘Financial adventures of the entreprise as heap of financial date are buried them. They simplify the comprehensive of financial statistics.

On the basis of above it may be concluded that ratios are very important for interpretation as they give valuable and very useful information about business.
Limitations:

Every flower of rose has its own beauty in spite of numberless thorns in the same way ratio analysis has a variety of advantages, though it is not free from limitations, some of which are as below:
1. The formula for calculating each ratio is not well standardized.
2. No standard ratios are available for evaluating the significance of each ratio.
3. Ratio ignores non-monetary factors like general economic climate, government and management policies, which vitally affect the financial health of the enterprise.
4. If too many ratios are calculated, they are likely to confuse, Instead of revealing meaningful conclusions.
5. The ratios are generally calculated from the past financial statement and thus, are no indicators of future.
6. Ratios are not exact measure of financial situation as the balance sheet and profit and loss account are based on accounting conventions, personal judgments and recorded facts.

As ratios are simple to calculate, there is a tendency to over employ them, which lead to accumulation of mass data. However significant the ratio may they cannot replace business efficiency and decision-making. They do not provide mechanical solution to business problems.

Classification of Ratio:

Some writes have described that there are as many 42-business ratios. First of all it is necessary to ascertain the ratios for a particular study. The financial ratios may be classified in the various ways. If the nature and objective of calculating each ratio is given then the customary and convenient classification from the point of view of management and investors will be:

[A] Liquidity Ratio

These ratios throw the light upon the liquidity position of a concern the main ratios are:
1. Current Ratio,
2. Quick Ratio,
3. Absolute Liquidity Ratio,
4. Current assets to Total assets Ratio,
5. Debtors to Sales Ratio,
6. Working Capital Turnover Ratio,
7. Debt - Equity Ratio,
8. Propriety Ratio

[B] Profitability Ratio

These ratios X-ray the profit making ability of the enterprise. They may calculate either on the basis of operating profit or net profit. These ratios are of two types first related to sales and second profitability. The main efficiency ratios are

1. Net Profit Margin
2. Net profit ratio
3. Return on gross capital employed
4. Return on net capital employed
5. Return on net worth
6. Return on Shareholder's Equity
7. Return on Equity Capital
8. Earning Per Share,
9. Dividend Percentage,
10. Dividend Pay-out Ratio,
11. Dividend Yield Ratio
12. Total Assets Turnover
13. Fixed Assets Turnover
14. Current Assets Turnover

(C) Management of receivable

Management of trade credit is commonly known as Management of Receivables. Receivables are one of the three primary components of working capital, the other being inventory and cash, the other being inventory and cash. Receivables occupy second important place after inventories and thereby constitute a substantial portion of current assets in several firms. The capital invested in receivables is almost of the same amount as that invested in cash and inventories. Receivables thus, form about one third of current assets in India. Trade credit is an important market tool. As, it acts like a bridge for mobilization of goods from production to distribution stages in the field of marketing. Receivables provide protection to sales from competitions. It acts no less than a magnet in attracting potential customers to buy the product at terms and conditions favourable to them as well as to the firm. Receivables management demands due consideration not financial executive not only because cost and risk are associated with this investment but also for the reason that each rupee can contribute
to firm's net worth. The import and commonly used receivable management ratios are as under:

1. Size of Receivables
2. Growth in Annual Sales and Receivables
3. Size of Debtors
4. Size of Receivables
5. Size of Loan and Advances
6. Average Receivables Turnover Ratio
7. Receivables of Sales Ratio
8. Average Collection Period

(D) Management of cash

The term cash management refers to the management of cash resource in such a way that generally accepted business objectives could be achieved. In this context the objectives of a firm can be unified as bringing about consistency between maximum possible profitability and liquidity of a firm. Cash management may be defined as the ability of a management in recognizing the problems related with cash which may come across in future course of action, finding appropriate solution to curb such problems if they arise, and finally delegating these solutions to the competent authority for carrying them out. The choice between liquidity and profitability creates a state of confusion. It is cash management that can provide solution to this dilemma. Cash management may be regarded as an art that assists in establishing equilibrium between liquidity and profitability to ensure undisturbed functioning of a firm towards attaining its business objectives. The import and commonly used cash management ratios are as under:

1. Cash to Current Assets Ratio,
2. Cash to Safes Ratio,
3. Cash Turnover Ratio,
4. Cash Position Ratio,
5. Net Cash Flows to Current Liabilities Ratio,
6. Coverage of Current Liabilities ’Ratio,

[2] Trend Analysis

Trend analysis technique is useful to analyze the firm financial position and to put the absolute figures of financial statement in more understandable form over a period of years.
This indicates the trend of such variable as sales cost of production, profit assets and liabilities.

The different approaches of trend analysis are as follow:

1. COMMON SIZE VERTICAL ANALYSIS and
2. COMMON SIZE HORIZONTAL ANALYSIS

Trend analysis helps the analyst and management to evaluate the performance, efficiency and financial condition of an enterprise.

1. COMMON SIZE VERTICAL ANALYSIS

All the statement may be subject to common size vertical analysis a figure from the same year’s statement is compared with the basic figure selected from the statement should be converted in to percentage to some common base. The common size vertical income statement and balance sheets of group of companies covered by this study are given in the study.

2. COMMON SIZE HORIZONTAL ANALYSIS

When asking horizontal analysis, a figure from the account is expressed in terms of same account figures from selected base year. It is calculation of percentage relation that each statement then bears to the same item in the base year. Horizontal analysis can help the analysis to determine how an enterprise has arrived at its current position.

The technique of common size statement is very useful when we wish to compare the performance of one company with that of another for presentation of the data in percentage form since it eliminates problems relating to differences in organization size.

3. Comparative statement Analysis

Statement prepared in a form reflecting financial data for two or more periods are known as comparative statements. The data must first be properly set before comparison in the preparation of comparative financial statement uniformity is essential otherwise comparison will be vitiated. Comparative financial statement is very useful to the analyst because they contain not only the data appearing in a single statement but also information necessary for the study of financial and operating trends over a period of a year. They indicate the direction of the movement in respect of financial position and operating results. Comparison of absolute figures has no significance if the scale of operations of one company is much different from that of others.
1. **Comparative Balance-Sheet:**

Increase and decrease in various assets and liabilities as well as in proprietor’s equity or capital brought about by the conduct of a business can be observed by a comparison of balance sheets at the beginning and end of the period. Such observation often yield considerable information, which is of value informing an opinion regarding the progress of the enterprise and in order to facilitate comparison a simple device known as the “comparative balance Sheet” may be used.

2. **Comparative Income Statement:**

As income statement shows the net profit or net loss resulting from the operations of a business for designated period of time. A comparative income statement shows the operating result for a number of accounting periods so that changes in absolute data from one period to another may be started in terms of money and percentage. The comparative income statement contains the same columns as the comparative balance sheet and provides the same type of information.

As the income statement presents the review of the operating activities of the business and the comparative balance sheet shows the effect of operation of its assets and liabilities. The latter contains a connecting link between the balance sheet and income statement. Income statement and balance sheet are contemporary documents and they highlight certain important facts.

[4] **Cash Flow Analysis**

The balance sheet is in the nature of a showing the position of a firm at a particular moment of time. The business process is very dynamic with transactions occurring regularly, each of which affects in some way, the immediately preceding financial position. A balance sheet therefore, merely provides the picture of a fleeting condition at a point of time and if balance sheets drawn at different time are compared any different pound between the closing and beginning figures would be the result of various transaction taking place during the interim period. The business process involves a continuous inflow and outflow of cash. This cash flow analysis helps the analysis to appraise the impact of the management’s decision on the business during a given period of time.

[5] **Other Techniques of Analysis**

Several other techniques like fund flow analysis and break-even analysis are also some time useful for analysis. The use of various statistical techniques is also used frequently for financial analysis, providing a more scientific analysis. The tools generally applied are
moving average, index number, range, Standard deviation, correlation, regression and analysis of time series. Diagrammatic and graph orientations are often used in financial analysis. Graphs provide a simplified way of presenting the data and often give much more vivid understandable of trends and relationships. Pie graphs bar diagrams and other simple graphs are often used for financial analysis.
REFERENCES: