CHAPTER I
CHAPTER 1

FINANCIAL MANAGEMENT - AN OVERVIEW

1.1 Introduction

Financial performance of any organization mainly depends upon the financial management practices in vogue. Finance in the modern business world is the lifeblood of the business economy. Financial management is concerned with the planning and controlling of the firm's financial resources. The role and responsibilities of a finance manager have undergone a marked transformation than ever witnessed earlier. The finance manager has now become an integral part of the business enterprise and is involved in the activities that take place in the enterprise. Until recently, finance executive was considered as keeper of books of accounts and provider of funds needed by the firm. But today his responsibility is not limited to procurement of funds but extends to allocating funds so pooled among profitable outlets and controlling the uses of funds. Since all the business activities like marketing, purchase and production involve cash planning and utilization of generated funds, the finance manager must take cognizance of his involvement in all the activities of the firm. He must also have clear conception of the overall objective of his firm as he has to act in conformity with the objectives (Kuchhal, S.C.: 1992). Furthermore, he has to evaluate the effectiveness of financial decisions in the light of some standards.

1.2 Evolution of Financial Management

Financial management as stated earlier, is broadly concerned with the acquisition and use of funds by a business firm. It emerged as a distinct field of study at the turn of the century. Its evolution may be divided into three broad phases: the traditional phase, the transitional phase and modern phase (Prasanna Chandra, 2002).

1.3 Concept of Financial Management

Finance is the motive power that rotates the wheels of the business. Financial management has a profound impact on the business efficiency of any enterprise. Generally finance denotes the provision of funds for certain specific purpose at a time when it is needed. Business finance is "that business activity which is concerned with the acquisition and conservation of capital funds in meeting financial needs and overall objectives of the firm (Kulaindaiswamy, V., 2002).

Financial management has become a challenging area of business management dealing with a variety of complex decisions in respect of liquidity, profitability and growth of the organization, management of assets and projects.
According to James Van Horne, “The term financial management cannotes that the flows of funds within the firm are directed according to some plan (James C. Vanhorne.: 1982).

Josep Massie. “Financial management is the operational activity of a business that is responsible for obtaining and effectively utilising the funds necessary for efficient operation”.

Weston and Bringham, “Financial management is an area of financial decision making, harmonizing individual motives and enterprise goals”.

Howard and Upon, “Financial Management is the application of the planning and control functions to the finance function”.

1.4 Scope of Financial Management

Traditionally the subject mater of financial management was confined to a narrow view of procuring funds for the enterprise. The whole focus is how to provide funds for the enterprise and from what sources funds can be raised. This involves composition of different sources and institutions, procedure for raising capital and legal and other formalities to be followed. The role of financial manager was restricted to such traditional activities like keeping accurate records, providing information and preparing reports. Financial manager was called upon to assist in solving specific finance related problems like shortage of cash or when there is need for obtaining additional funds.

The role of financial manager has vastly expanded in recent times. A business becomes larger and when the competition grows the financial decision making becomes more complex. In addition to acquiring funds from different sources and deciding about its composition and structure, financial manager is equally responsible in allocating the funds among different alternative avenues of investment, and deciding how the total volume of funds should be committed for different activities or among different assets of the enterprise. This is called allocation decision. Considerations such as liquidity, profitability, risk, growth, diversification of the enterprise etc., are some of the important considerations in allocating the resources of the enterprise for different investments (Kulaindaiswamy. V: 2002).

The third dimension of the financial management is the efficient utilization of the funds invested, by means of such decisions, which is meant to exercise control over competitive performance by means of certain financial tools. By means of financial tools norms can be developed for efficient decisions on such matters.
whether the new proposal for investment can be accepted? Whether the working
capital is adequate to support company’s operation? And on what rate dividend can be
declared and how much a firm should earn to meet out the cost of capital? Financial
management thus is “primarily concerned with developing skills needed to make
correct decisions in fast moving and technologically complex corporate environment”.

1.5 Goals of Financial Management

Efficient management of flow of funds within the firm implies the existence of
some objective or goal. Judgment as to whether or not a financial decision is efficient or
not must be in the light of such objectives (Nakkiran. S.:2002). Financial management
has the following objectives.

1. Maximization of profit: Profit maximization is a simple and straight forward
statement of purpose. It is easily understood as a rational goal for a business and
focuses the efforts towards making money. However it is often vague and does not
state clearly whether it is the same as the return per share-holder or does it include
long-term profit or short-term profit only.

2. Maximization of wealth: Rather than focusing directly on profits, this goal
emphasises the impact of profit on the earning per share and current market value of
the firms’ securities, notably common stock. Higher earnings per share does not
automatically lead to the enhanced market value of the firm’s securities. Other factors
such as rate dividend paid to share holders and the level of debt in the capital structure
determine the value of the firm’s securities that is wealth of share holders.

3. Maximization of utility: Long-term relevance and sustainability of any
organization depends on the clients or users of the organization’s product or service.
The perception of benefit by the users of the service or product is called utility. As
long as a firm is able to satisfy the utility of its users, it can retain the competitiveness
in the market place. This objective is more relevant in client centered or user oriented
organization like cooperatives.

4. Maximization of welfare: Every business organization has a responsibility towards
the larger society. As a ‘Corporate citizen’ it has to fulfill the social responsibilities
such as paying fair wages to employees, fair price for the customers, improving
working conditions and providing social security measures to the workers. The social
responsibility is also reflected in adopting environmental friendly policies, using the
resources of the community at optimum level and adopting cost-effective methods.
1.6 Social Objectives

The modern firm has another objective, to assume social responsibility. Banking a socio-economic organ, a business enterprise has a responsibility towards various sections of the society. This is necessary not only because society provides environment conducive to the operation of business enterprise but also for their survival. No organization can exist any longer without its social acceptance. It is usually contended that pursuit of social objective interferes with the economic objectives of an enterprise because social activities will raise costs and risks. Assumption of social obligations by business is, therefore, likely to weaken the economic viability of the firm and pose threat to its existence (Srivastava R.M: 2002).

1.7 Functions of Financial Management

Finance functions may be broadly classified into two groups (Varma M.M & Agarwal R.K: 1999) namely; A) executive finance function and B) incidental finance functions.

1.7.1 A. Executive Finance Function:

It is so termed because it requires administrative skill in planning, execution and control of financial activities. Some of the executive finance functions are given below.

1. Financial forecasting: It is to forecast the financial needs to the concern. In estimating the financial requirements of the concern, help of various types of budgets i.e., sales budgets, production budget etc. prepared by the concerned department of the firm, profit and loss account and balance sheet and other related data is sought.

2. Investment Policy Decision Establishing Assets – Management Policies: In order to estimate and arrange for cash requirements of an enterprise, it is very necessary to decide how much cash will be invested in fixed (non-cash) assets and how much in short term or current assets, which are normally convertible into cash within a year. The investment decision involving the fixed assets is known as capital budgeting. The investment policy of fixed and current assets is popularly known as asset management policy; establishing a sound assets-management policy is a prerequisite to the successful financial management.

3. Dividend Policy Decision or Allocation of Net profit: How to allocate the net profit of the concern is another problem. One important element in dividend decision is the pay out ratio i.e., how much of the net profits should be paid out to the share
holders. It will depend on the preference of the shareholders, investment opportunities available within the firm and the factors determining dividend policy in practice.

4. **Cash Flows Requirements**: A good financial executive should ensure that cash inflows and outflows must be continuous and uninterrupted. Inflow of cash originates in sales and cash outflows or cash requirements are closely related to volume of sales. Here the financial manager is to decide how much cash must retain to meet the current obligations so that there would be no idle cash balance earning nothing for the company.

5. **To Decide the Borrowing Policy**: Any organization plans for the expansion of the business for which it requires additional resources. Personal resources being limited the cash must to be arranged by borrowing money. The financial manager, at this juncture, will take a decision about them when the funds from outside sources are needed, the sources from which they are to be received, how long they will be needed and form what sources they will be repaid.

6. **Negotiations for New outside Financing**: Finance functions does not stop with the decision to undertake the outside financing. It extends towards carrying negotiations from the outside finance agencies to arrange for it. The financial managers must assess short and long-term financial requirements of the organization and start negotiation for raising these funds.

7. **Checking the Financial Performance**: The financial manager is under an obligation to check the financial performance of the funds invested in the business. It requires retrospective analysis of the operating period to evaluate the efficiency functional planning.

1.7.2 B. **Incidental Finance Functions**: Incidental finance functions are those functions of clerical or routine nature. Which are necessary for the extension of decision taken by the executives? Some of the important incidental finance functions are:

   a. Supervision of cash receipts and disbursements and safeguarding of cash balance.
   b. Proper custody and safeguarding of the important and valuable papers, securities, and insurance policies.
   c. Taking care of all mechanical details of the financing.
   d. Record-keeping and reporting
   e. Cash planning and credit management.
1.8 Financial Analysis

The company's financial information is contained in three basic financial statements, the balance sheet, the trading and profit and loss account and the profit and loss appropriation account (Pandey, I.M: 1995). These statements are very useful to different parties concerned such as management, investors, creditors and others to form judgment about the operational efficiency and financial position of the company. These statements may be more fruitfully used if they (statements) are analyzed and interpreted to have an insight into the strengths and weaknesses of the firm. The success of the company’s financial plans is based on the financial analysis which is the starting point for making plans, before using and sophisticated forecasting and budgeting procedures.

Various tools are employed by the interested parties in analyzing the financial information contained in these financial statements and the Ratio analysis is one of them. Ratio analysis is the process of determining and interpreting numerical relationship of different items of financial statements. It provides a yardstick to measure the relationship between variable and figures. This relationship can be expressed as percent or as a quotient (one item as a certain number of times the other items).

1.8.1 Meaning of Ratio Analysis

The information given in the financial statements serves no useful purpose unless it is interpreted and analysed in some comparable terms. The ratio analysis is one of the tools in the hands of those who want to know something more from the financial statements. Ratio analysis is the process of determining and presenting the arithmetical terms of the relationship between figures and group of figures drawn from those statements. Ratio is the basis of this analysis. A ratio may be defined as ‘the indicated quotient of two mathematical expression’ and as ‘the relationship between two or more things’. An accounting figure conveys some meaning of it and is related to some other relevant information. For example, if we say that a firm has earned a net profit of Rupees one lakh, it looks very impressive, but the firm’s performance is said to be good or bad only when the net profit figure is related to the firm’s totaling figure. Expressed mathematically it is known as a financial ratio (or simply as a ratio). The ratio can be calculated by dividing one figure by the other, the quotient so obtained in the ratio of the figure.
1.8.2 Standards of Comparison

A single ratio in itself shows nothing and does not indicate favourable or unfavorable condition. It should be compared with some standard to make it meaningful. Standards of comparison may consist of:

1. Past ratios calculated from the past financial statements of the same firm.
2. Ratios developed using the projected or proforma financial statement of the same firm.
3. Ratios of some selected firms, especially the most progressive and successful at the point in time.
4. Ratios of the industry to which the firm belongs.

Usually, the past ratios are used as standards of comparison to evaluate the performance of the firm by comparing the present ratios with the past ratios. It gives an indication of direction of change and reflects whether the firm’s performance and financial position has improved or deteriorated or remained constant over the period of time. The comparison is valid only if the firm’s accounting procedures, practices and policies have not changed over time.

Sometimes projected ratios are developed to compare them with the past ratio. This comparison shows the firm’s relative strengths and weaknesses in the past and in the future. If the future ratios show weak financial position, corrective measure can be initiated. The ratios of the firm may also be compared with the ratios of some progressive competitive firm to know the relative financial position and performance of the firm. The ratios may also be compared with the average ratios of the industry to which the firm is a member to determine its place in the total performance of the industry.

1.8.3 Significance of Ratio Analysis

Mainly the persons interested in the analysis of the financial statements can be grouped under three heads-(i) owners or investors, (ii) creditors, and (iii) financial executives. The importance of analysis varies materially with the purpose for which it is calculated. The primary information seeks to obtain from these statement differs considerably reflecting the purpose that the statement is to serve.

The significance of these ratios varies for these three groups as their purpose differs widely (Jain Premila: 1996). The investors are mainly concerned with the earning capacity of the organization whereas the creditors including bankers and financial institutions are interested in knowing the ability of enterprise to meet its
timely financial obligations. The financial executives are concerned with evolving analytical tools that will measure and compare costs, efficiency, liquidity and profitability with a view to making intelligent decisions.

The significance or importance of financial ratio analysis can be judged from the following facts.

1. **A useful tool in the Hands of Analyst:**

   Ratios are exceptionally useful tools with which one can infer the financial performance of the enterprise over a period of time. With the help of ratio analysis conclusions can be drawn regarding several aspects such as financial health, profitability and operational efficiency of the undertaking. The financial health of the concern can be known with the help of different ratios. Ratios point out firm’s liquidity position to meet its short-term obligations and long-term solvency. They indicate strengths and weaknesses of the firm in this respect.

   Ratios can also pinpoint the operating efficiency of the firm i.e., whether the management has utilised the firm’s assets correctly to increase the investors wealth. Ratio is also indicative of overall profitability of the concern. It ensures a fair return to its owners and secures optimum utilization of firm’s assets. Thus, ratios are useful tools in the hands of management and others concerned to evaluate the firm’s performance over a period of time by comparing the present ratio with the past ones.

2. **Inter-firm Comparison:**

   Ratio analysis provides inter-firm comparison or comparison with industry averages by comparing the firm’s ratios with those of other competitive and progressive firms. An inter firm comparison exhibits the firm’s relative position Vis-à-vis its competitors. If comparison shows a variance, the possible reasons of variations may be identified and if results are negative, the corrective actions may be initiated immediately to bring them in line. It is also helpful in forewarning the corporate sickness and helps the management to take corrective action.

3. **Trend Analysis:**

   Ratio analysis enables a firm to take the time dimension into account. In other words, it facilitates the management to know whether the firm’s financial position is improving or deteriorating or is constant over the years by setting a trend with the help of ratios. The analyst with the help of ratio analysis can know the direction of movement whether favourable or unfavourable (*Vyuprakesh Sharma: 2005*). An
analysis of the trend of strategic ratios may help the management in the task of planning, forecasting and controlling.

Thus, ratio analysis plays a very important role in the interpretation of the financial statements correctly and to make the figures comparable and more meaningful.

1.8.4 Limitations of Ratio Analysis

Ratio analysis suffers from a number of drawbacks:

1. Difficulty in comparison due to – (i) different procedures and practices followed by different firms, (ii) different accounting periods, (iii) every firm differs in age, size etc.
2. Prices level changes between two periods.
3. Conceptual diversity-different meanings of the terms.
4. Accounting limitations.
5. Several ratios to draw conclusions
6. Ratio analysis conveys observations.
7. Ratios may be misleading.

1.9 Funds Flow and Cash Flow Statements

Every company prepares its balance sheet at the end of its accounting year. It reveals the financial position of the company at a certain point of time. It does not present any analysis. It is simply a statement of assets and liabilities of the concern on a particular date. Its usefulness is, therefore, limited for analysis and planning purposes. The statement of sources and application of funds serve the purpose, which is popularly known as ‘Funds Flow Statement’.

Funds flow statement is a widely used tool in the hands of financial executives for analyzing the financial performance of a concern (Sivasubramaniam A.P. 1986). Good concerns always prepare such statement along with the balance sheet at the end of the year. This statement shows how the activities of a business have been financed or how the available financial resources have been used during a particular period. But it is quite different from income statement which is primarily a presentation of revenue and expenses items and computation of net income for the period while the funds flow statement is a report of financial operations of a business understanding. It generally reports changes in current assets and current liabilities and is much useful for financial executives, financial institutions and creditors for the analysis of financial position of the concern.
1.9.1 Meaning of Fund Flow Statement

The funds flow statement is a report on financial operations changes, flows or movements during a specified period of time. It shows the sources and uses of funds or how funds have been used during a particular period of time. It differs from the income statement because it does not show items as income or expenditure items but covers all movements that involve an exchange of assets. It is regarded as a complementary statement analyzing the sources and uses of funds. The statement has been assigned various titles from time to time.

**Funds defined.** The term ‘fund’ is interpreted differently by different thinkers. Some define it as literal cash and some other as cash and marketable securities. But the term is used most often for working capital or net current assets. Now an interpretation of the term has developed as to include assets or financial resources which do not flow through the working capital accounts.

1.9.2 Objectives

1. **Analysis of financial position:** It analyses the sources of funds and their applications during a given period. Financial manager can reduce the reasons for imbalances and correct them.

2. **Evaluation of the firm’s financing:** It reveals how the firm financed its developmental projects.

3. **An instrument for allocation of reserves:** It puts forth an order of priorities for various projects and helps in arranging finances for them.

4. **Tool of communication to outside:** It communicates to the outside world valuable information regarding the firm’s financial position.

5. **Future guide:** It helps the financial management in planning its financial requirements for the future and their nature too. It can device financial policies of the firm for the future based on the information provided by the statement.

6. **A control device:** The analysis can be comparable with the budgeted figures to find out the deviations so that they may be corrected in time.

1.9.3 Procedures for Preparing Funds Flow Statement

In the modern technique of funds flow statement, two statements are prepared (A) schedule of changes in working capital and (B) fund flow statement. Changes in working capital are to be calculated first and it forms a component of fund flow statement.
There are the four steps involved in the preparation of the fund flow statement:

1. Ascertain the funds from the operation
2. Preparation of the statement of the change in working capital
3. Computation of any missing figures as to profit or loss on sales of the fixed assets, put purchase or the sale of fixed assets and the amount of depreciation of fixed assets etc.,
4. Finally preparation of funds flow statement.

There are two parts of funds flow statement (i) Sources of funds and (ii) Application of funds. Transactions that increase working capital are called sources of funds and transactions that decrease working capital are termed uses of funds. If the working capital of a concern increases during an accounting period more funds are generated by its transaction than are used. And if working capital decreases, more are used than are generated.

1. 9.4 Sources of Funds. These are the following sources of funds.

1. **Funds from Operations:** Sales minus all trading expenses and cost of goods sold. Such items which do not affect the working capital are not included. In calculating funds from operations, necessary adjustments are made in the profits shown by profit and loss account as under.-

   **A) Items to be added to profits:** (i) Non-fund items and (ii) Non-trading charges or losses.
   
   *i) Non fund items:* These include. - (a) depreciations and depletion (b) amortization to fictitious and intangible assets (c) provision for taxation.

   *ii) Non-trading charges or losses:* - (a) appropriation of retained earnings (b) proposed dividend or shares (c) loss on sale of non-current assets.

   **B) Items to be deducted from Net Profits:** (i) dividend received or receivable (ii) Re-transfer on excess provisions (iii) profit on sale of non current (iv) Appreciation of fixed assets on revaluations.

2. **Funds from issue of shares capital:** Including share premium or reducing discount on issue of shares.

3. **Funds from issues of debentures, acceptance of public deposits and other long term loans:** Not included if debentures are issued for consideration other than cash.

4. **Sale of fixed assets:** Not include if exchange for other asset.

5. **Non trading receipts:** e.g. dividend, rent, interest etc.

6. **Decrease in working capital:** As shown by schedule of working capital.
1.9.5 Application of Funds

1. Loss from operations.
2. Purchase of fixed assets. If not purchased for consideration other than cash.
3. Repayment of loans, redemption of debenture or preference capital. Including premium or discount on redemption.
4. Payment of dividend. Proposed dividend not included.
5. Other application of funds. Any loss involving in cash.
6. Increase in working capital. As per schedule of changes in working capital.

1.9.6 Cash Flow Statement

Meaning of cash flow statement. Cash flow statement is like funds flow statement with a difference that funds here mean only cash and not the working capital (Varma M.M & Agarwal R.K:1999).

Preparing cash flow statement: In preparing cash flow statement, items appearing in income statement are to be computed on cash basis rather than to compute on accrual basis. It is divided in two parts (i) Sources of cash and (ii) Application of cash and is also prepared in two forms (i) Report form and (ii) Account form.

Sources of cash: Include cash from operations, collections from debtors, sale of investment and fixed assets, issuance of share capital and debenture and loans etc.

Application of cash: Include decrease in accounts payable, purchase of fixed assets, dividend paid, repayment of loan, redemption of preference shares or debentures etc.

Cash from operations: Cash from operations may be computed as follows. - Cash from operations = cash sales - (cash purchases + cash operating expenses after adjusting accruals and prepayments). It may also be resulted by adjusting profits of profit and loss account by non-cash items.

1.9.7 Uses of cash flow statement:

1. Useful in planning and coordinating financial operations.
2. It is a control device, comparing cash flow statement and cash budgets.
3. Useful to internal financial management.
4. Profit and cash position can be compared.
5. Helpful in short term financial decision.
1.10 Financial Management in District Central Cooperative Banks

1.10.1 Introduction

Cooperative banking is the biggest unit of the cooperative movement in our country. It is equally the oldest among all cooperatives, where cooperative banking institutions were started as early as 1904. Short-term cooperative credit structure consists of three-tier system, which is uniformly followed in all major states (Kulaindaiswamy, V: 2002).

The District Central Cooperative Bank operates in a particular district, which is its area of operation. In certain special cases two central cooperative banks operates in the same district. Central cooperative banks are leaders in their districts in guiding the banking activities for their members. They admit all types of primary cooperative societies and provide banking and financial services. They compete with commercial banks in mobilizing deposits and have opened branches in all centers of a district. Of late their operation have been modernized with inducing efficient personnel trained in various banking and financial operations.

The financial management is that managerial activity which is concerned with the planning and controlling of the firms' financial resources. Finance in the modern business world is the life blood of the business economy. We can’t imagine a business without finance. Financial management has a profound impact on the business efficiency of any enterprise. Generally the finance denotes the provision of funds for certain specific purpose at a time when it is needed. Business finance is that business activity which is concerned with the acquisition and conservation of capital funds in meeting financial need and overall objectives of the firm.

Financial management has become a challenging area of business management leading with a variety of complex decisions in respect of liquidity, profitability and growth of the organization, management of assets and projects.

According to James Van Horne: "The term financial management cannnotes that the flows of funds within the firm".

Financial management plays an important role in cooperative enterprise. Sound financial planning and management is the most vital requirement for successful management. A study of business failures in cooperatives would reveal that majority of such failures resulted from the lack of proper financial management. Inefficient
functioning of cooperatives is due to bad debts, excessive overdue or unwise investment. The financial management, similar to the private or public sector corporations have their own distinctive features. The principles, the practice, the legal basis, performance criteria and financial base of cooperatives are not the same as prevails companies or public enterprises.

1.10.2 Goals of Financial Management in Cooperative Banks

The financial management in cooperative banks has the following goals (Nakkiran. S :2002).

1. **Maximizing surplus**: As cooperative banks are not meant for earning profit, they have to increase the surplus in order to increase its service to the employees and to meet all genuine expenses.

2. **Minimize Risk**: A sound financial management must anticipate financial risks and must try to reduce it. Forecasting such risks is an important aspect of financial management.

3. **Maintain Control**: Control over the flow of finance and safeguarding its utility are major aspects of financial control. Then the cash flow must be watched and monitored.

4. **Achieve Flexibility**: during the times of uncertainties and surplus seasons balance must be maintained.

1.10.3 Features of Financial Management in Cooperatives

1. The most significant feature of the financial management in cooperatives is that the cooperatives depend on their membership for business as well as debt financing which limits the capital base and renders them financially vulnerable.

2. Selling shares to members has its own limitations and is not likely to bring substantial capital because of the following reasons:
   a. Membership is restricted to a homogeneous group in a particular geographical area.
   b. Shares are kept at low par value to enable even men of small means to subscribe them.
   c. Limited interest, Ltd voting rights and non transferability features make it unattractive to private investors and
   d. Share capitals do not form a truly permanent capital since they are redeemable at cost and have no market value.
3. Cooperatives not being profit seeking organizations distribute the major portion of their surplus earnings, to their members as patronage refunds in proportion to the value of each member’s transaction as a result of which entrepreneurial capital is not accumulated.

4. As regards the use of loan capital, the private enterprises make use of every opportunity of external capital by maximizing the borrowings, where as cooperatives believe in self-help and place a ceiling on the maximum borrowing power.

5. Above all the efficiency of the financial management in a cooperative organization cannot be solely judged by the profit criterion. Any increase in the value of the firm should be construed as being the result of the members own contributions, since cooperatives mainly transact with their members patrons. Cooperatives are not expected to earn profit from the transaction with the members, since their ultimate object is the welfare of the members.

1.10.4 Importance of Financial Management in Cooperatives

Cooperatives, as district economic organizations can not follow the same methods of the financial management techniques followed by other enterprise. They are different from public sector organizations, in their objectives, approach, management, vision and accountability to members and the society. Hence, they have to follow a selective financial approach.

1. Capital formation of cooperatives is oriented towards self-reliance in resources. The purpose of mobilization of resources is not for appreciation of the value of shares.

2. The shares of the cooperatives are not transferable and they cannot be traded like the shares of corporate sector. Hence, the value of shares is not appreciated or depreciated in the market; they remain the same for ever.

3. Cooperatives raise resources from members and from their higher financial agencies. Dependence on open market is unknown among the majority of the cooperatives.

4. An urban cooperative depends on the deposits and they raise deposits facing stiff competition from commercial banks and unorganized sector.

5. Financial management techniques in cooperatives are needed for prudent application of resources and to avoid wastage. Hence keeping the cost of capital low is an important consideration for the managers of cooperatives.
6. The benefits of financial management are transferred to the members of cooperative even during the middle period by way of reduced prices, higher rate for deposits, etc., They need not wait till the end of the year, where profit distribution is made.

7. The prudence of financial management lies in indicating the sources of finance, which are cheaper and less riskier.

8. One area, which needs greater emphasis of financial management in cooperatives, is the loan recovery area and related issues. Due to poor recoveries the NPA of cooperatives are increasing, which increases the interest burden, penal rate etc., when funds are locked due to poor recovery they become sick units.

9. Dividend policy followed by majority of the cooperatives is not healthy one. For years, members are not disbursed dividend and several cooperatives never disburse dividends. Such policy needs modification and hence the relevance of efficient financial management.

10. To make the new principles of cooperation, ‘Member Economic Participations’ more relevant, greater emphasis should be laid on matured financial management.

**1.10.5 Function of Financial Management in Cooperative Banks**

The basic function of financial management in any organization including the cooperative banks is to maintain its liquidity and profitability. But cooperatives eschew profit and strive to earn a surplus. Following are the important functions of financial management.

1. **Raising of funds**: Cooperative banks raise their funds by way of owned funds and borrowed funds. Owned funds consists of share capital and reserve funds. Borrowed funds consist of deposits and borrowings from other agencies. Cooperative banks must concentrate on raising more deposits in the open market.

2. **Deployment of funds**: The funds raised must be employed for more productive purposes, proper ‘credit planning’ must be applied.

3. **Forecasting cash flows**: Cash inflows must match cash outflows. The banks must forecast the timing of inflows and use them to pay its creditors and loan operations.

4. **Cost Control**: When money is spent on various items the cost of such investment must be noted periodically.
5. **Pricing**: Pricing a product or a banking service is another aspect of financial function. The financial manager can supply important information on costs, changes in costs of production or services and profit margin. This helps to follow an ideal price policy which can help to market a product or services and to maintain a profit margin.

6. **Measuring Cost of Capital**: Different sources of funds received by a firm or a bank may have different conditions and cost. Short-term debt may be costlier than long-term debt. This must be measured and a return must be assured for capital.

7. **Forecasting profits**: A successful financial management must predict future profits. For this the current costs and variable costs must be calculated to assure a reasonable profit.

8. **Managing Assets**: A firm's assets must be carefully managed and a number of decisions must be made on their use. The financial manager coordinates his activities with other managers and decides to increase or stabilize assets.

9. **Managing funds**: Funds are the liquid assets of firm. Cash and liquid assets come under the category: The financial manager must guarantee the finance receivables and inventories are must.

1.10.6 **Professionalizing Financial Management in Cooperatives**

Cooperative societies handle finance functions traditionally though there have been satisfactory growth in their size, business volumes and have covered a wide variety of investment. But owing to traditional attitude about financial hardships either in raising funds or effective use of available funds, some cooperatives have investment and return problems, others have inadequate funds and many are in the grip of mismanagement of finance functions. The reasons of this miserable plight is due to conspicuous absence of a body of systematic and specialization knowledge shaping and regulating the financial management of the cooperatives suitable to their situations and conditions. As a result, the board of directors, the chairman or the finance manager of the cooperatives are managing the finance functions on the basis of the provisions of cooperatives act and rules, others enactment, trial and error and experience, hence, the cooperatives business lack standards, uniform and dynamic finance functions.

Under the situation, there is the need that the growing cooperative sector must develop a sound and systematic body of knowledge and expertise of managing finance functions which will lead it toward professionalism providing a solid footing
for all round development maximizing the value of the cooperatives business to its shareholders. A value of cooperatives is represented not by market price of the ordinary shares like private sector business but by the services and benefits financial and non financial rendered to the shareholders of the cooperatives (Sah A.K. 1986). The other reasons emphasizing professionalizing financial management are as follows.

a) **Separation of ownership and control:** Although ownership of the cooperative is diffused to the shareholders, it is operated on behalf of them by the shareholders, and by the bureaucratic set up of the paid employees. These employees practically execute and control policy decisions of the board.

b) **Reconciling Diverse Interest:** The cooperative is both a social and economic organization. As an economic organization it has to balance the financial requirements of various facts of business like marketing, production, personnel and other functions, to have stability with worth. While acting as social institution it has to reconcile the diverse interest of the share holders, customers, employees' suppliers and government. The judicious blending of social and economic interests demand professional approach to the financial management.

c) **Creating impact on the economy:** The behaviour and performance of cooperative business is one of the windows which ventilate socio-economic condition of common people. It is a key to understand modern economic society. Hence, the subject of business finance is to be studied from the stand point of its impact on the operations of the economy.

d) **Solution to various problems:** Last but not least, for providing effective services to the common masses, the cooperative must solve its basic problem the problems of competition, problems generated by the growing size of the business, uses of modern technologies, efficient use of on eliminating mismanagement an so on. Solutions to these problems are possible through the application of organized knowledge of management not only in the field of finance but also in all the areas of the enterprise.

**1.11 Aspects of Financial Management in Cooperatives**

**1.11.1 Financial planning:** Financial planning is the life blood of business and it is required in business for a variety of purposes. Finance is needed. a) to acquire fixed assets such as machinery and equipment b) to acquire working or current assets, cash and inventories and c) to meet working expenses like wage, rent etc. Careful planning
and forecasting is necessary in order to determine the quantum of funds needed in business. The profitability of the business depends directly on the optimum use of the funds which are scare and which are acquired at a cost. Every organization must aim at simultaneously fulfilling the twin objectives of efficient utilization of funds and at the same time keeping adequate cash on hand to meet current and capital expenses. The financial planning involves planning in three aspects viz., cash planning, planning working capital and planning fixed capital.

a) Cash budget: Planning and estimating the cash needs is the most vital aspect of financial management. Cash includes cash on hand and at bank. The objective of cash management is to maintain the liquidity of the business and its ability to meet payment obligation at the same time without affecting the profitability. For efficient cash management cash budget is prepared. Cash budget involves. a) estimation of timing and amount of cash receipts b) estimation of expenditure involving cash and its timing c) collecting the receipts and meeting the expenditure and d) forecasting the requirement of additional cash. In the preparation of cash budget, transaction involving cash alone are taken into account. Seasonal variations are also taken into account, while making estimations of cash needs. Cash budget is prepared on the basis of the estimation of cash inflow and cash outflow. Therefore, cash budget is also called flow analysis. “Cash flow is a movement of cash. Cash spent is an outward cash flow and cash received is an inward cash flow, quite irrespective of whether these expenditure and receipts are for capital or revenue items” cash inflow may be due to. a) cash sales b) rent, interest, dividend c) collection of account receivable d) sale of securities sale and fixed assets. Cash outflow results because of a) wages and salaries b) administrative and selling expenses c) factory expenses d) payment of interest f) repayment of loan g) income tax, sale tax h) purchase of fixed assets i) payment of dividend, redemption / withdrawal of shares.

An ideal financial management will be that in which the cash inflow balances cash outflow. Nearer the financial manager to this objective the better he can strike between profitability and liquidity. The difference between cash receipt and cash payment forms the surplus or deficit cash. Daily cash needs are forecasted on that basis and arrangements are made to meet excess cash needs or for investment or surplus cash in sufficient quantities. Certain norms may be evolved, which may guide the financial manager in effectively managing the cash.
a. Percentage of cash to the current assets
b. Percentage of cash to the total resources / assets
c. Rate of rotation (velocity) of cash i.e., annual sales divided by average deposits; percentage of cash to the net annual sales; Number of days of sales the cash balance represents.

b) Planning for working capital: Business organization need two types of capital viz., working capital and fixed capital. Working capital is needed to meet the current commitments such as cash, investment in inventory, payment of advances to suppliers, selling on credit terms etc. The management of working capital is of strategic importance, because in many organizations, particularly in trading and banking organizations, working capital forms the major portion of the assets. Besides, working capital is capable of yielding quick result. The working capital should be maintained always at an optimum level because the reduction in the working capital will increase the profitability and at the same time inadequate working capital will retard the effectiveness of the performance. The financial manager is directly concerned with management of working capital so that it yield maximum result. He can achieve the task by ensuring that the funds are committed to a short period and that there is less of account receivable. Better management of inventories will also significantly influence the working capital management, because the funds required is directly dependent upon the rate of rotation of inventory. Appropriate level of stock can be maintained by accurate sales forecast.

Estimating the Working Capital Needs

Taking into account the above mentioned factors, a firm has to make correct estimation of the working capital needs. In order to estimate the needs of the working capital certain tools and techniques are adopted. They are

1. Forecasting for the requirements of funds
2. Funds flow analysis
3. Working capital budget

Zero –Base Budgeting

Zero – base budgeting is a method of budgeting which aims at controlling costs of operation and containing inflation. In this approach prior funding levels are ignored at all activities. Each activity competes equally for incremental funding based on the costs, benefits and priorities. The process is highly participative and takes into accounts the goals, objectives and priorities established for each budget unit. This
method can be applied to all areas of business except manufacturing. Zero – base budgeting approach may achieve significant benefits not only in cost control but also in improving the management process and organizational and operational methods.

**Capital budget**

Capital budgeting means budgeting the capital expenditure over a period of time. In the capital budgeting the long range monetary benefits have to be assessed against the investment outlay, on the basis of which investment alternative are evaluated and selected. The capital budgeting is a complicated process because. a) it involves higher capital outlay b) it pertains to a long term period during which time value of money changes. While preparing capital budget, following steps have to be completed.

1. Enumerate the capital expenditure sort out alternatives for each capital expenditure; give priority to each category and serialize in the order or priority; classification and selection.

2. For determining the investment alternatives and for classification and selection of the most profitable one, following methods of evaluation are used.

1. **Pay Back Period:**
   
   It is the method of determining in how many years the investment would pay back itself. It is a simple method commonly used to judge the desirability or otherwise of an investment. The pay back period is arrived at by dividing the cost of investment by annual returns \((P=C/R)\). If the cost of investment is Rs.50000 and the annual return expected is Rs.5000; the pay back period will be 10 years. Selection of a project on the basis of pay back period has meaning only when the life of a project is not less than the pay back period.

2. **Rate of Returns.**
   
   Rate of returns represents the actual power of the firm. It means wealth added to the current investment. Investment is equal to all the items in the assets side of the balance sheet whereas, earning is the book profit before income tax and interest on loan.

   \[
   \text{Profit (r)} = \frac{\text{Profit}}{\text{Assets}} \times 100
   \]

   For example if investment is Rs. 10000 and the annual average return is Rs. 2500, the rate of returns \((r)\) is 25%. It is profitable if the organization is able to borrow capital at the lesser rate than the rate of returns.
3. Net Present Value Method:

It is based on the time value of money. A rupee realized next year or after 2
year or 5 years does not have the same value as the rupee realized today. Therefore,
the return that we expect to get is discounted at certain percentages and the net cash
benefit received is arrived at. The present value or a rupee realized at a future period
is compared with the initial investment. A proposal is acceptable under this method, if
the following criteria are met, when the present value of the future expected cash
inflow is more than the present value of initial investment and future cash outflow, or
when the discounted rate is more than the cost of the capital.

The net present value may be computed with the help of the following equation

\[ NPV = \frac{R_1}{1 + K} + \frac{R_2}{(1 + K)^2} + \frac{R_3}{(1 + K)^3} + \frac{R_4}{(1 + K)^4} \]

- \( NPV \) = Net present value
- \( R \) = Cash inflow at different time periods
- \( I \) = Initial investment
- \( K \) = Rate of interest

1.11.2 Sources of Capital

The Problem of raising resources is not a critical factor as long as the
cooperatives are small and serving the limited needs of members. But in recent years,
cooperatives have grown in size whose capital requirements are substantial, and
whose functions are complex. In the changed circumstances of large scale operations,
capital intensive operation aiming at short term results, the cooperatives have to
device newer methods of raising capital, beside the traditional ones.

Methods of raising capital

Different methods are practiced by cooperatives of various countries for
raising resources suiting to the needs and circumstances under which such
cooperatives are functioning. The common methods resorted to by the cooperative
banks to generate capital may be discussed under the following heads.

1. Equity capital: (a) Sale of shares of stock (b) Collection of members capital
contribution
2. Accumulation of Reserves
3. Loan capital : a) Deposits, b) Borrowings, c) Sales of bonds and debentures
e) Donations, grants and gifts.
Financial Leverage

The method of using debt financing to enhance the returns to equity a holder is known as financial leverage. This implies that the cheaper debt financing will be a favourable factor (lever) to enhance the earning per share. Cooperatives lower price and do not seek higher rate of returns on invested capital. In cooperatives, share capital and reserves are cheaper source of capital, while debt capital (loan and deposits) are costlier. Hence, higher the proportion of borrowed capital higher will be the overall cost of capital. Thus, high leverage (i.e. higher proportion of borrowed capital) would defeat the very objective of cooperatives. Cooperatives must therefore aim at lowering the proportion of borrowed capital, and thereby reduce the overall cost of capital. The cost of capital can be reduced by one or more of the following measures.

- Increasing the share capital
- Increasing the reserves
- Reducing the borrowings from financing banks and redeeming loans earlier
- Increasing the proportion of low cost deposits and loans in the borrowed capital.

- The overall cost of capital can be expressed in the following equation

\[ K_o = \%S(Ks)+ \%R(Kr) + \%L(Kl) + \%D(Kd) \]

Where

- \( K_o \) = Overall cost of capital
- \( Ks \) = Cost of share capital
- \( Kr \) = Cost of reserves
- \( Kl \) = Cost of loans
- \( Kd \) = Cost of deposits

\( \%S \) = Proportion of share capital in the total capital
\( \%R \) = Proportion of reserve in the total capital
\( \%L \) = Proportion of loans in the total capital
\( \%D \) = Proportion of deposits in the total capital

C. Financial Control

Procurement of needed funds and their deployment in different channels of investments are nothing but the two sides of the same coin and as much diligence, prudence and care should be exercised in the method of investment as in raising resources. According to V.S. Alenne, “The chief problem in cooperative finance is to use capital both membership capital and loan capital in a manner that most
The basic objectives of cooperatives are different from those of joint stock companies whose aim is profit maximization and or asset maximization. The cooperatives, in the light of the supreme objective of maximization of service to their members, employ their precious resources in a judicious and prudent manner. There are four points to be observed in the application of cooperative's finance in order to ensure optimum utilization of available resources. They are a) there should not be unnecessary stock of merchandise b) there should not be excessive accounts receivable c) there should not be unnecessarily large bank balance d) there should not be too much investment in establishments, buildings, furniture etc. It is necessary to confirm whether the above criteria are followed and to ascertain the soundness of the financial management. The ratio analysis provide an extremely valuable guide in analyzing and evaluating the financial conditions and operations of cooperatives.

Finance is concerned with a wide range of business decisions like size of the firm, rate of growth, asset mix, project mix, project evaluation. Financial analysis, finance mix and a host of other areas, to make optional decision in these areas, the financial management in a cooperative enterprise consists of three major aspects viz.,

1. Financial planning
2) Determining the sources of finance
3) Financial control.

1. **Financial planning:**

Financial planning means deciding in advance, the financial activities to be carried on to achieve the basic objectives of the firm. The basic objective of the firm is to get maximum profit out of minimum efforts or to maximum the wealth of the cooperative to its shareholder in an efficient manner. So the basic purpose of financial planning is to make sure that adequate funds are raised at minimum cost and that they are needed widely. In cooperatives, profit is not the motive and a financial plan has to deal with raising and deploying resources.

**Definition:** “Financial planning pertains only to the function of finance and includes the determination of the firms financial objectives formulating and promulgating financial policies and developing financial procedures” – Walker – Boughn (Sahoo.S.K & Sahoo S.C : 1991).

Financial planning is concerned with the determination of objectives, policies, schedules and programmes that the enterprise tries to achieve leading to the
accomplishment of its basic objectives, financial planning includes short range and long range planning. It is concerned with the determination and evaluations of capital structure such as share capital and borrowed capital, and sources and uses of capital.

a) Need for financial planning

Financial planning plays a very important role for the smooth running of business. Their importances are as follows (Nakkiran, S : 2002).

1. **Conservation of Capital:** Effective utilization of capital is necessary to conserve the value of investment in assets in an industry. Because new investments reduce the value of old machineries financial planning can only conserve the value of capital.

2. **Economy and coordination:** Financial planning is required to reduce the waste in the production process and to coordinate the various activities in an industry to get the best results.

3. **Changing price level.** The price level increase the replacement cost of the assets and the management is to arrange for that through proper planning.

4. **Success of entire firms.** It depends upon how the financial planning is being implemented.

5. **Rapid expansion of public sector:** This fact also intensified the need of financial planning in private sector because it has now become very difficult to get finance from financial institutions and banks due to pressure from public sector undertakings.

6. **Optimum capital structure at minimum cost:** Financial planning is necessary for deciding about the capital structure at an optimal level and minimum cost.

7. **Unity in action:** Execution at all levels take similar decision in similar cases. To create unity among them careful planning and forecasting is necessary in order to determine the quantum of funds needed in business. The profitability of the business depends directly on the optimum use of the funds which are scared and which are acquired at a cost. Every organization must aim simultaneously at fulfilling the twin objectives of efficient utilization of funds and at the same time keeping adequate cash on hand to meet current and capital expenses.
b) Main Aspect of Financial Planning

1. **Determining financial objectives:** There are two types of financial planning objectives i.e., long term and short term. The LT financial objectives of the firm should be to utilize the resources effectively and economically. These objectives include (i) Proper capitalization (ii) Capital structure. The short term financial objectives should be to maintain the liquidity of funds in the business.

2. **Formulating Financial Policies:** The second aspect is to formulate certain financial objectives. Such policies may be regarding the estimation of capital requirements, relationship between firm and creditors, form of securities, sources of capital, distributions of earnings, etc.,

3. **Developing Financial Procedure:** This aspect relates to the control and administration of financial activities. For this purpose financial activities are sub-divided and authorities are delegated to subordinates to perform such activities. Standards are established and actual performance is compared to the standards. Any deviation is then controlled through various tools such as budgetary control, cost control etc.

4. **Reviewing financial plan:** The plan should be reviewed from time to time in the light of changing economic, social and business environment.

c) Financial Management and Welfare of Members

As far as cooperatives are concerned the efficiency in financial management is not confined to the enterprise level efficiency or the efficiency in the transformation process. Equally important is the welfare of the members and the extent to which the financial management has contributed towards these objectives. It can be judged in two ways; one is the service surplus and the other is patronage refund (Kulaaindaiswamy, V: 2002).

1. **Service surplus:** One of the objectives of cooperatives is ‘service by least cost’. This approach places cooperative in a situation where profit is less relevant. “Net Profit” thus become only one indicator of the overall financial result, and some analyses must be made to estimate the ‘service surplus’ going beyond the cooperative’s accounts. The service surplus is the sum total of the financial benefits passed on to members when the cooperative price or fee is lower than the market rate.
2. *Patronage Refund:* This represents the financial benefits passed on to a member, which is referred to as ‘patronage refund’ in cooperatives literature. This practice, which reflects the non profit character of cooperatives, makes provision for passing on a portion of the net profit to the members in recognition of their business patronage, the source of profit. The following formula is used to compute the patronage dividend for each member.

\[ \frac{\text{TPR}}{\text{TVB}} \times \text{MVB} = \text{MPR} \]

Where

- **TVB** = Total volume of Business
- **MVB** = Volume of business contributed by the members
- **TPR** = Total amount allocated for patronage refund/ distribution
- **MPR** = Amount of patronage refund due to an individual member.