**Funds Management - A Theoretical Perspective**

The primary objective of funds management in banks and this chapter briefly explains the concept of funds, preparation of funds flow statement, funds management in commercial banks and cooperative banks, announcing requirements for funds classification and different types of rating given by banks.

### 4.1 The concept of funds

The term ‘funds’ are commonly used in the financial circles in different meanings. The three main dimensions of the term ‘funds’ are used here are working or operating capital and to the total financial resources. In this chapter, the concept of funds as working capital or also as current capital can also in this study 'funds' related to the management of current or working capital includes that part of assets requirements to carry on the routine operations and working resources. The success and efficiency of an organization or an enterprise depend on effective utilization of funds considered as working capital. Working capital includes current assets or those in the form of cash or cash at bank.
CHAPTER-IV

FUNDS MANAGEMENT – A THEORETICAL PERSPECTIVE

The primary objective of the study is to examine the funds management in DCBs and this chapter briefly explains the concept of funds, preparation of funds flow statement, funds management in commercial banks and co-operative banks, accounting techniques for funds management and different types of ratios used by banks.

4.1 The concepts of funds

The term 'funds' has been used in the financial circles in different senses. The three most common usages of the term 'funds' are to refer to cash, to working capital and to the total financial resources. However, the concept of funds as working capital is the most popular one and in this study 'funds' refers to working capital. Working capital includes that part of total capital which is used for carrying out the routine or regular business operations. The success and efficiency of an organisation to a large extent depends on effective utilisation and management of working capital. Working capital can be gross working capital or net working capital. Gross working capital is defined as total of current assets (current assets include cash in hand, cash at bank,
Net working capital is defined as current assets minus current liabilities.

4.2 **Funds flow statement**

Flow of funds means changes in the amount of funds or net working capital. A funds flow statement is a statement of sources and uses of funds. There is said to be flow of funds when a business transaction results in a change, either in an increase or decrease in the amount of funds or net working capital. If a transaction results in an increase in the amount of fund, it is considered as a source of fund. If a transaction results in a decrease in the amount of funds it is taken as an application of funds or use of funds. If a transaction does not cause any change in the amount of funds, then there is no flow of funds i.e. there is neither a source of fund nor an application of funds.

A funds flow statement is useful in knowing the sources and uses of funds, in suggesting the ways in which working capital can be improved, in planning temporary investment of idle funds, in planning a sound investment policy, in assessing the efficiency of the management in the utilisation and mobilisation of funds, in forecasting the flow of funds and in projecting the working capital requirements. It also indicates how much of the net working capital is provided by
funds from operations and the causes for the financial
difficulties faced by a concern, such as improper mix of short
term and long-term funds, unnecessary accumulation of fixed
assets, etc.

4.3 Preparation of funds flow statement

The preparation of funds flow statement involves the
preparation of schedule of changes in working capital,
preparation of statement showing the funds from operations and
preparation of funds flow statement.

4.4 Schedule of changes in working capital

The schedule of changes in working capital is the
statement which shows the changes in working capital that
occur during the current year. Working capital represents the
excess of current assets over current liabilities. Since
several items, i.e., all current assets and current liabilities
are the components of working capital, it is necessary, in
order to ascertain the working capital or funds at the
beginning and at the end of the period, to measure the
increase or decrease therein and to prepare a statement or
schedule of changes in working capital. A proforma of
schedule of changes in working capital is given in Chart 4.1.
Chart 4.1 Schedule of changes in working capital

<table>
<thead>
<tr>
<th>Items</th>
<th>Previous year</th>
<th>Current year</th>
<th>Effect on working capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock</td>
<td>a₁</td>
<td>c₁</td>
<td>a₁ - c₁ = e₁</td>
</tr>
<tr>
<td>Debtors</td>
<td>a₂</td>
<td>c₂</td>
<td>a₂ - c₂ = e₂</td>
</tr>
<tr>
<td>Cash</td>
<td>a₃</td>
<td>c₃</td>
<td>a₃ - c₃ = e₃</td>
</tr>
<tr>
<td>Bank</td>
<td>a₄</td>
<td>c₄</td>
<td>a₄ - c₄ = e₄</td>
</tr>
<tr>
<td>Bills receivable</td>
<td>a₅</td>
<td>c₅</td>
<td>a₅ - c₅ = e₅</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>a₆</td>
<td>c₆</td>
<td>a₆ - c₆ = e₆</td>
</tr>
<tr>
<td>Total (a) Rs.</td>
<td>Ea₁</td>
<td>Ec₁</td>
<td>Eei</td>
</tr>
<tr>
<td>b. Current Liabilities</td>
<td>b₁</td>
<td>d₁</td>
<td>b₁ - d₁ = f₁</td>
</tr>
<tr>
<td>Bills payable</td>
<td>b₂</td>
<td>d₂</td>
<td>b₂ - d₂ = f₂</td>
</tr>
<tr>
<td>Outstanding expenses</td>
<td>b₃</td>
<td>d₃</td>
<td>b₃ - d₃ = f₃</td>
</tr>
<tr>
<td>Total (b) Rs.</td>
<td>Σb₁</td>
<td>Σd₁</td>
<td>Σf₁</td>
</tr>
<tr>
<td>c. Working Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Difference between (a) and (b)</td>
<td>Σa₁ - Σb₁</td>
<td>Σc₁ - Σd₁</td>
<td>Σe₁ - Σf₁</td>
</tr>
<tr>
<td>Increase/decrease in working capital</td>
<td>(Σa₁ - Σb₁) - (Σc₁ - Σd₁)</td>
<td>(Σe₁ - Σf₁)</td>
<td></td>
</tr>
</tbody>
</table>
4.5 **Statement showing the funds from operations**

The current operations of the business are the most important single source of funds and over the long run they are the largest source of funds. The funds from operations can be ascertained by preparing a statement called the statement of funds from operations. A proforma of this statement is given in Chart 4.2.

**Chart 4.2. Statement showing the funds from operations**

- **Closing credit balance of profit and loss appropriation account**: xxx

- **Add** non-fund and/or non-operating debit items or expenses which have decreased the net profits, but do not decrease the funds from operations. (All the items given on the debit side of the adjusted profit and loss account) xxx

- **Less** non-fund and/or non-operating credit items or incomes which have increased the net profits, but do not increase the fund from operations (All the items given on the credit side of the adjusted profit and loss account) xxx

- **Less opening credit balance of profit and loss appropriation account**: xxx

- **Trading profit or funds from operations**: xxx
4.6 Preparation of funds flow statement

In the funds flow statement, those transactions which will result in an increase in the amount of funds (sources of funds) and those which will result in a decrease in the amount of funds (uses of funds) will appear. Funds from operations or the operating losses would appear in the funds flow statement. Above all, the increase or decrease in working capital as indicated by the schedule of changes in working capital, also should appear in the funds flow statement. Chart 4.3 exhibits the different items that will appear in funds flow statement.

Items like funds from operations, issue of shares and debentures, long-term and medium-term borrowings, long-term and medium-term deposits, sale of fixed assets, etc. will appear on the side of sources of funds. Uses of funds include funds from operations, redemption of shares and debentures, repayment of long-term and medium term loans and deposits, purchase of fixed assets, etc.
Chart 4.3. Funds flow statement

Funds management in commercial banks is a complex task. It is not possible for the banks to deploy all the funds they have mobilised because of the statutory rules. Earning a fair return on capital and meeting the demands for money when they occur are the dual tasks of funds management. In other words, the sources and uses of funds need to be arranged in such a way that the funds are liquid. A commercial bank, like any other business enterprise, aims at securing the maximum margin of profit between the borrowing, lending and investment operations. The sources of funds in the past are acquired by raising them in the part.

The sources of funds in terms of a balance sheet form are capital, reserves, provisions, borrowings and refinancing liabilities and provisions (1992, N.S., 1994, pp. 265-269).

<table>
<thead>
<tr>
<th>Sources of funds</th>
<th>Rs.</th>
<th>Uses of Funds</th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Funds from operations</td>
<td>e₁</td>
<td>1. Funds lost in operations</td>
<td>f₁</td>
</tr>
<tr>
<td>2. Non-operating or non-trading income</td>
<td>e₂</td>
<td>2. Non-operating or non-trading expenses</td>
<td>f₂</td>
</tr>
<tr>
<td>3. Issue of shares</td>
<td>e₃</td>
<td>3. Redemption of redeemable preference shares</td>
<td>f₃</td>
</tr>
<tr>
<td>4. Issue of debentures</td>
<td>e₄</td>
<td>4. Redemption of debentures</td>
<td>f₄</td>
</tr>
<tr>
<td>5. Borrowings of long-term and medium-term loans</td>
<td>e₅</td>
<td>5. Repayment of long-term and medium-term loans</td>
<td>f₅</td>
</tr>
<tr>
<td>7. Sale of long-term investments</td>
<td>e₇</td>
<td>7. Purchase of long-term investments</td>
<td>f₇</td>
</tr>
<tr>
<td>8. Sale of fixed assets</td>
<td>e₈</td>
<td>8. Aquisition or purchase of fixed assets</td>
<td>f₈</td>
</tr>
<tr>
<td>9. Decrease in working capital</td>
<td>Σe₁-Σf₁</td>
<td>9. Increase in working capital</td>
<td>Σf₁-Σe₁</td>
</tr>
</tbody>
</table>

The financial statements of the banks will reveal the funds they have mobilised minus statutory reserves. Earning a fair return on capital and meeting the demands for money when they occur are the dual tasks of funds management. In other words, the sources and uses of funds need to be arranged in such a way that the funds are liquid. A commercial bank, like any other business enterprise, aims at securing the maximum margin of profit between the borrowing, lending and investment operations. The sources of funds in the past are acquired by raising them in the part.
Funds Management in Commercial Banks

Funds management in commercial banks is more complex due to the day to day fluctuations and frequent flow of funds. It is not possible for the banks to deploy all the funds they mobilise because of the statutory obligations. So, their net disposable resources will equal the funds they have mobilised minus statutory reserves. Earning a satisfactory return on capital and meeting the demands for money when they occur are the dual tasks of funds management in banks. In other words, the sources and uses of funds need to be arranged in such a way as to keep the bank funds as liquid as possible.

Flow of Funds in Commercial Banks

A commercial bank, like any other business enterprise, aims at earning sufficient margin of profit out of the borrowing, lending and investment operations. Commercial banks raise funds with a view to employ them profitably. The working of these funds is reflected in the pattern of assets acquired by mobilising these funds.

The sources of funds in terms of the new balance sheet format introduced by the Reserve Bank of India with effect from March 1992, are share capital, reserves, deposits, borrowings and refinance liabilities and provisions (Toor, N.S., 1994, pp.265-269).

The flow of funds in commercial banks is exhibited in Chart 4.4.
Chart 4.4 Flow chart of funds in commercial banks

**SOURCES**

- Share capital
- Reserves
- Deposits
- Borrowings
- Liabilities & Provisions

**USES**

- Statutory Reserve
- Loans & Advances
- Investments
- Fixed Assets
- Other Assets

**Funds**

- Reserves and surplus
- Net income
- Interest expense and Non interest expense

**Deposits**

- Borrowings
- Liabilities & Provisions

**Interest income and Non interest income**

**The share capital (paid up capital) contributed by members, share holders of the bank in cash. This capital is a permanent part of the bank’s resources.**

**Reserves**

- Statutory Reserve
- Loans & Advances
- Investments
- Fixed Assets

**Deposits**

- Borrowings
- Liabilities & Provisions

**Interest income and Non interest income**

**Liabilities & Provisions**

- Net income
- Interest expense and Non interest expense

**Income and expenditure**

- Net income
- Interest expense and Non interest expense

**Statutory Reserve**

- Loans & Advances
- Investments
- Fixed Assets

**Fixed Assets**

- Net income
- Interest expense and Non interest expense

**Other Assets**

- Net income
- Interest expense and Non interest expense

**Loans & Advances**

- Net income
- Interest expense and Non interest expense

**Investments**

- Net income
- Interest expense and Non interest expense

**Statutory Reserve**

- Net income
- Interest expense and Non interest expense
The share capital (paid-up capital) is contributed by members or shareholders of the bank in cash. This capital is a permanent part of the bank's resources in the sense that it has no maturity.

To ensure safety, a commercial bank maintains reserves like statutory reserve, capital reserve, revaluation reserve, revenue and other reserve, which are created out of undistributed profits. Actually, reserves are a part of paid up capital which is earmarked for contingencies. According to Section 17 of the Banking Companies Act, 1949, every banking company is required to transfer every year to the reserve fund a sum equivalent to 20 per cent of its annual profits.

Another important source of funds of commercial banks is deposits, like demand deposits from banks and others, savings deposits and term deposits from banks and others.

Commercial banks also raise funds through borrowings. They borrow funds mainly from the central bank. They also borrow funds from banks and financial institutions like Life Insurance Corporation, Industrial Development Bank of India, Unit Trust of India, etc.

The last source of funds is liabilities and provisions. Bills payable, interest accrued and others constitute this item.
Funds raised by commercial banks create a corresponding liability on the banks except share capital and reserves. As per the new balance sheet format introduced by Reserve Bank of India (RBI), banks utilise the amount raised for creating different assets. These include cash in hand and balance with RBI in current account and other accounts, balance with banks/money at call and short notice and balance with banks in current accounts, other deposit accounts and money at call and short notice with banks; investments in Government securities, other approved securities, shares, debentures and bonds in subsidiaries and/or joint ventures and others; advances including bills purchased, cash credit and overdraft and loans payable on demand and term loans; fixed assets like premises, other fixed assets (including fixture and furniture) and other assets like inter office adjustments, interest on investments not collected, tax paid in advance, stationery and stamps, non-banking assets acquired by others, etc.

4.9 Funds Management in DCBs

As per the "statistical statements relating to co-operative movement in India" (Government of India, 1942, p.15), working capital was considered as the total of paid-up share capital, reserve fund and other reserves, debentures, deposits and other borrowings. It includes all the major items on the liabilities side of the balance sheet. But it does not include other sundry liabilities and current year's
profit. The Kerala State Co-operative Societies Rules, 1969, Section 2 (k) defined working capital as follows:

"Working Capital" means such portion of the reserve fund, other funds, paid-up share capital, loans and deposits received by a society and debentures issued by a society as have not been invested in buildings and other fixed assets (Government of Kerala, 1969).

Both these definitions record the major components of funds. These definitions are more or less similar with the exception that the second one includes fixed assets as well. The quantity of working capital in accordance with the legal definition is the amount of working funds available for banking operations and for meeting the day-to-day requirements. The concept of working funds generally used in financial institutions is also akin to this.

Like other financial institutions, co-operative banks should also conduct their activities in such a manner as to conform to the efficient business norms for collecting funds from different sources and in the manner in which such funds are utilised. Due weightage should be given to the liquidity and safety of their funds along with profitability in the funds deployment. For ensuring liquidity, maintenance of maximum balance of cash and other liquid assets has been prescribed by the RBI.
4.10 Flow of Funds of DCBs

The inflow and outflow of funds in DCBs is exhibited in Chart 4.5.

**Chart 4.5 Flow chart of funds in DCBs**

**SOURCES**
- Share capital
- Reserves
- Deposits
- Borrowings

**USES**
- Statutory Reserve
- Loans & Advances
- Investments
- Fixed Assets

The flow of funds in DCBs involves the inflow of funds from sources such as share capital, reserves, deposits, and borrowings. These funds are then used for various purposes including statutory reserves, loans and advances, investments, and fixed assets.

DCBs maintain different types of reserves like statutory reserve fund, agricultural credit stabilisation fund, dividend equalisation fund, building fund, other fund, etc. The reserve fund is indivisible; the members do not have a claim on them. The third source of working capital of DCBs is deposits.

The DCBs tap funds through different types of deposits like current, savings, bank, fixed, money at call and short notice, and recurring.

**Sources of Funds in DCBs**

- Share capital
- Detailed members and borrowings from state co-operative banks, RBI, and NABARD minus fixed assets.
Sources of Funds in DCBs

The sources of funds of a DCB consist of share capital, reserves and other funds, deposits from members and non-members and borrowings from state co-operative banks, RBI, and NABARD minus fixed assets.

The share capital of a DCB is subscribed by the affiliated societies and individual members. The face value of shares varies from Rs.50 to Rs.100. The affiliated societies are bound to subscribe to the shares in proportion to their borrowings.

DCBs maintain different types of reserves like statutory reserve fund, agricultural credit stabilisation fund, dividend equalisation fund, building fund, other reserves, etc. Since the reserve fund is indivisible, the members do not have a claim on it.

The third source of working capital of DCBs is deposits. The DCBs tap funds through different types of deposits like current, savings bank, fixed, money at call and short notice and recurring.

Another important source of working capital is borrowings from other agencies such as loans from state co-operative banks, Government, RBI/NABARD and commercial banks. The maximum limit of borrowings of DCBs is fixed in their bye-laws.
4.11 Uses of funds in DCBs

DCBs utilise the mobilised funds for keeping statutory reserves, for granting loans and advances, for purchase of fixed assets and for investing in different types of securities.

According to section 18 of the Banking Regulation Act (as applicable to co-operative societies) 1966, DCBs have to keep three per cent of their total demand and time liabilities as liquid cash. Again under Section 24 of the said Act, these banks are also required to maintain 25 per cent of total demand and time liabilities (DTL) in the form of liquid assets, in addition to the cash reserve of three per cent. Hence, the remaining 72 per cent of the bank's deposit resources is available to it for lending or investment, according to priorities.

The DCBs utilise a major part of their funds for granting short-term loans upto 12 months for financing seasonal agricultural operations and for medium term loans for a period ranging from one to three years for the purchase of bullocks, milch cattle, pump sets, digging or repairs of wells and improvement of land.

The DCBs invest their funds in premises and building, furniture and fixtures, vehicles, library and quarters
whenever there is a need. These banks also invest their funds in Government securities.

In the present scenario of Co-operative Banking in Kerala, there are two main problems - Primarily, the co-operative banks are not able to utilise the entire funds available for deployment and secondly the bottom line of net profit situation of many co-operative banks is not fully satisfactory. These two aspects are inter-dependent in the sense that if the deployment of funds is optimal, the profit situation also will be correspondingly better. The income earned would depend not only on the degree of utilisation of funds but also on the interest yield realised on the advances made. Hence, there is sufficient scope for further improvement or the fuller utilisation of funds available as well as the revenue surpluses generated by the co-operative banks. In the following chapters an attempt is made to explore this possibility.

4.12 Accounting techniques for funds management of DCBs

At present, there is no field of management where accounting tools/aids are not used. Figure 4.1 makes clear the significance of accounting techniques to the various management processes such as organising, planning, co-ordinating, controlling, etc. Among the many accounting techniques, the most frequently used one is ratio analysis.
Figure 4.1 Techniques of Accounting

Source:
4.13 Ratio analysis

Ratio analysis involves an analysis of the inter-relationships between various items in the profit and loss account and balance sheet. It is a very useful tool in measuring the financial performance and financial strength of any business organisation. Comparison of financial ratios of a concern for a given period with that of the past or with that of the other firms, or with its own prescribed standards will not only measure its comparative financial position and financial strength, but will also pin-point areas which require corrective measures. The different ratios used by banks are:

1. Spread, burden and profitability ratios
2. Credit/deposit ratio
3. Borrowings/deposits ratio
4. Borrowed funds/owned funds ratio
5. Liquid assets/demand and time liabilities ratio
6. Demand deposits/term deposits ratio
7. Deposits/working capital ratio
8. Borrowings/working capital ratio
9. Liquid assets/working capital ratio
10. Loans and advances/working capital ratio
11. Investments/working capital ratio
12. Total overdue/total demand ratio
13. Manpower expenses per employee
14. Volume of working funds per employee
In this chapter, we made an attempt to review the theoretical framework behind funds management. In the succeeding chapters an effort is made to examine the funds management and the related issues of the selected DCBs.