V. **FINANCIAL MANAGEMENT:**

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V. Financial Management: Its role in Small Business

5.1. Financial Management – its importance in business:

Financial management is the conscious effort to formulate long-term policies relating to major aspects of financing, investment and growth decisions with a view to accomplishing the objectives of the firm. The strategic decisions about the different finance functions, which go far beyond the traditional concept of procurement of funds have to take into consideration, the growth strategies and marketing policies, all of which must ultimately become interacting and interdependent part of the same whole.

The commercial world has been changing with the revolutionary industrial and business developments. To cope with these ever-increasing developments and financial management complexities, the authorities in the field of accounting and finance have introduced different financial management tools. Maximization of profit or 'surplus' is the primary objective of an organisation. This objective can be achieved by increasing the cash inflow or by decreasing the cash outflow. In practice, both reduction in the cost of production and increase in the total turnover are aimed at profit maximisation i.e. the better result of a business unit. Realisation of this objective reflects the efficiency and security of the organisation’s investment decision. This leads to an increase in the volume of the ownership.
Therefore, efficient and scientific management of finance in an enterprise is of prime importance for achieving the ultimate goal (Sen, Jain and Bala, 2002). In practice, the matter of production or quality or marketing/sales in the ultimate analysis relates to financial issues.

Financial Management touches on all other business function (Carsberg and Edey, 1969). Most of the business decisions have financial implications and a single decision will often have consequences with financial implications in several different parts of an organisation. Finance is regarded as the lifeblood of a business enterprise. This is because in the money-oriented economy, finance is one of the basic foundations of all economic activities (Maheshwari, 1994). Hence, efficient management of every business organisation is closely linked with efficient management of its finances. An important function of financial management is the coordination of the various decisions taken within an organisation so that they are mutually consistent, having regard for financial aims and constraints. Financial Management is vital for the success of a business, whether it be small or large. Good financial records must be constantly maintained in business if it is to have effective financial control (Pickle and Abrahamson, 1990).

The development of number of management skills and decision-making techniques facilitated to implement a system of optimum allocation
of the firm’s resources. As a result, the scope of financial management has also changed. The emphasis shifted from episodic financing to managerial financial problems, from raising funds to efficient and effective use of funds (Pandey, 1995). The modern approach is an analytical way of looking into the financial problems of an organisation. Financial management is considered a vital and an integral part of overall management. To quote Ezra Solomon “In this broader view the central issue of financial policy is the wise use of funds and the central process involved is a rational matching of advantage of potential uses against the cost of alternative potential sources so as to achieve the broad financial goals which an enterprise sets of itself”. Thus in modern business organisation, the finance functions are said to influence production, marketing and sales and other functions of the firm. This in consequence, will affect the size, growth, profitability and risk of the firm and ultimately, the value of the firm (Pandey, 1995). To quote Ezra Solomon “… the function of financial management is to review and control decisions to commit or recommit funds to new or ongoing uses. Thus, in addition to raising funds, financial management is directly concerned with production, marketing and other functions with in an enterprise whenever decisions are made about the acquisition or distribution of assets”.

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For the effective execution of the managerial finance functions, routine functions have to be performed. Some of the routine finance functions are:

1. Supervision of each receipts and payments and safeguarding of cash balances;
2. Taking care of the mechanical details of new outside financing;
3. Record keeping and reporting.

The financial decisions have a great impact on all other business activities. The new approach to financial management may be broadened to include profit-planning function also. The term profit planning refers to the operating decisions in the areas of pricing, costing, volume of output and the firm's selection of product lines. Profit planning is, therefore, a pre-requisite for optimising investment and financing decisions.

Financial control is one of the major thrust areas of management, which deals with the proper utilisation of financial resources in a way that optimises the possibilities of beneficial decisions in terms of sound financial health of the organisation (Rao and Pramanik, 1996). The emphasis of Financial Control, therefore, lies on effective decision-making by the managers whereby it advocates the application and understanding of organisational behaviour, techniques and theories of behavioural sciences in
the area of financial management with a view to evolving the most pragmatic 
solutions of the financial problems in totality.

Therefore, Financial management has become an integral part of 
general management function. In the process it considers various aspects of 
management accounting in order to determine a number of policies, 
pertaining to credit, inflow and outflow of funds, financial analysis, 
inventory control, receivable management, payable management, budgetary 
control, working capital management, etc. with an aim to draw a beneficial 
plan of the whole capital structure of the organisation. These may facilitate 
the process of appraisal of the financial performance of the organisation (Rao 
and Pramanik, 1996).

Financial management, in today’s organisation put stress on the 
preparation of performance standards, measurement of financial transactions 
through proper record-keeping, evaluation of actual performance and 
designing of several intervention strategies of management – action for 
corrective action. So financial management in modern organisation should 
not only be conversant about the application of management functions but 
also needs the continuous flow of information in a systematic way, both as 
input and feed-back, which produces opportunities of confront uncertainties 
of both external and internal environment of the organisation (Rao and 
Pramanik, 1996).
Managing finance is no longer that simple as it used to be in the decades gone by. Political and economic conditions have changed so vastly and have become so complicated all over the world that finance has to be handled with variety of strategies and methods to achieve the desired results.

Commercial history is replete with examples where firms have been liquidated not because the technology was obsolete but because there was a complete mismanagement of financial affairs (Rao, 1999). Thus, it is clear that just as man and machine are to be managed properly, finance has also to be well managed.

It will be useful here to quote Peter Drucker "there are the costs of today and costs of tomorrow. I know of no business today which operates at such a rate of return that it can meet the costs of tomorrow. With today’s rate of inflation, businesses are not making profit but only destroying capital. One of the primary tasks of management is to reduce the costs of tomorrow and extract the maximum possible out of available capital".

Superficially, it is the job of an owner-manager of a business of having enough money to meet merchandise bills and payrolls and the like, as they become due in time. Fundamentally, it is the job of establishing and following such sound financial policies that the ability to meet obligations promptly will follow as a logical consequence. Many concerns have more than ample capital for their needs but this capital may be so unintelligently
used as a result of unsound financial policy that they invite failure. If sound financial management policies are followed, sound financial condition would result.

Organisations with better management skills in that condition are better prepared to withstand economic storms or other unexpected misfortunes. Since in a free market economy only the fittest survive, ordinary business prudence requires that sound financial control be attained and consistently maintained.

Commenting on sound financial management policy by Holtzman and Lewis says that – A management (owner-manager) which understand and works in accordance with the following basic principles will find itself following sound financial policy:

I. An organisation’s investment in not ‘fixed assets should be in proper proportion to its tangible net worth (Tangible net worth is the amount of capital the owners have in the business exclusive of intangible assets such as goodwill, franchises and similar items).

II. Net working capital should be in proper position to sales.

III. Inventories should be maintained at a figure less than the net-working capital.
These principles of financial management are treated as fundamental as the law of gravity, they apply to all business concerns regardless of size.

Financial management is the conscious effort to formulate long-term policies relating to major aspects of financing investment and growth decisions with a view to accomplishing the objectives of the firm. The strategic decisions about the different finance functions, which go far beyond the traditional concept of procurement of funds have to take into consideration, the growth strategies and marketing policies, all of which must ultimately become interacting and interdependent part of the same whole.

The commercial world has been changing with the revolutionary industrial and business developments. To cope with these ever-increasing developments and the field of accounting and finance have introduced different financial management tools. Maximization of profit or ‘surplus’ is the primary objective of an organisation. This objective can be achieved by increasing the cash inflow or by decreasing the cash outflow. In practice, both reduction in the cost of production and increase in the total turnover are aimed at profit maximisation i.e. the better result of a business unit. Realisation of this objective reflects the efficiency and security of the organisation’s investment decision. This leads to an increase in the volume of the ownership. Therefore, efficient and scientific management of finance
in an enterprise is of prime importance for achieving the ultimate goal (Sen, Jain and Bala, 2002). In practice, the matter of production on quality or marketing/sales in the ultimate analysis relates to financial issues.

The paramount importance of finance in a business enterprise has lead to the development of the discipline of Financial Management. Initially it was considered to be an integral part of Financial Accounting. But during the last century, due to development of tools and techniques of Financial Management, it has come to be regarded as a separate branch of accounting. Financial Management is today considered to be different from financial accounting, cost accounting and even management accounting, though Financial Management is closely related to and to a great extent dependent upon, all these facets of accounting (Chatterjee, 1999).

Financial Management has three broad elements, namely Planning, Organisation and Control.

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<tr>
<th>Planning</th>
<th>Organisation</th>
<th>Control</th>
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<tr>
<td>* Ascertainment of financial needs</td>
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<tr>
<td>* Determination of sources of finance/funds</td>
<td>* Procurement of funds</td>
<td>* Monitoring of funds</td>
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<td>* Allocation of funds</td>
<td>(through 'financial discipline with regard to funds utilisation)</td>
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It shows that, accounting in a business organisation is by and large a service function – a staff function in management terminology. But Financial
Management is at least one area, which represents more a line function than a staff function.

5.2. **Financial Management in Small Business**:  

Financial Management is vital for the success of a business whether small or large. Good financial records must be constantly maintained in business if it is to have effective financial control (Pickle and Abrahamson, 1990). Sound record keeping and analysis can generally increase the possibility of solving many unseen problems early and easily. To prevent, their units from spinning 'out of financial control', a small business owner/manager "should start with good financial control system right up front so there is constant knowledge about what is going on" (Peters and Waterman, 1994). "Without this ongoing control, we would not be able to spot profitability of concerns or opportunities" says William McBride.

Many small business units would prefer to avoid the subject of financial management. No matter how small the business is, proper financial management is critical to its success. It is essential that the owner/manager become involved in this aspect of the business and understand the basic concepts of financial management. Although accountants may provide monthly statements and some advice but the owner/manager him/herself must understand the financial implication of the accounting information in
order to plan the future of the business. Many small business failures could have been prevented if the owner had understood their financial statements and know how to use them for decision making; (Kuchl and Lambing 1994).

Small Business with only one major decision-maker are in a unique position as only at this size can a firm manage without having to communicate business information to others. To match the present pace of change in the economy and maintain a competitive edge, the owner/managers of small business units must know personally in correct form the present position of his/her business. So, for small business enterprises to flourish, more sophisticated accounting tools can not be a luxury (Soral and Jain, 1994). As Waterman recommends that small business owners/managers should “look at this kind of information as a proactive management tool, not merely as historical information”. One classic study by Potts (1992) on Financial management and control techniques in small business concludes that “the clearest and most startling distinction between successful and discontinued small business lies in their approach to the use which can be made of accounting information”.

In the literature, it is generally agreed that the financial control system exists to ensure that economic resources of the enterprise are used effectively and efficiently in the pursuit of agreed objectives. It is an information system which has a structure of, possibly expense centres, product centres, profit
centres or investment centres and a process or set of procedures which govern the planning and control of resources (Roy and Hutchinson 1983).

Literature on the financial management of small business suggests that, there is a considerable number of reasons for believing that the financial management of small business units should be qualitatively as well as quantitatively different from a large organisation. There are various institutional differences such as regulatory influences, sources and types of finance and forms of financial assistance. In addition, quite distinctive inherent characteristics of small enterprises are likely to lead to differences [Levin and Travis (1987) and Petty and Bygrave (1993)] as follows:

- In large enterprises there is frequently separation between management and ownership, whereas small enterprises are more likely to operate as an extension of their owner-manager.
- Small businesses may be faced with fewer investment and financing options.
- Small business units often suffer from "resource poverty" particularly of a financial nature.
- Small business units are generally more likely to experience problems associated with the consequences of growth, such as liquidity pressure.
• Small business units' financial management is inevitably more dependent on the ability of a single-individual or a small number of individuals than is the case in large enterprises.

• The absence of well-formed market for ownership stakes in small enterprises is likely to impact on their financial management.

Therefore, it appears that there are a number of distinguishable characteristics of small enterprise, which are not considered in the maxims of modern finance theory. Owner-managers may lack diversification in financial investments because a large proportion of their wealth is tied up in the firm and because of the high cost of out-side funds. And also due to the total involvement of owner-manager in the management and operating activities of the firm.

In most researches concerning small business financial management strategies, it is assumed that the small business owner-manager bases decisions on a strategy aimed at increasing wealth as much as possible. But this assumption may not hold good (LeCornu, et. al. 1996). There may in fact be substantial differences which are not adequately captured by the normative goal of wealth maximization of owners and which therefore justify a modified financial objective function.

One of the characteristics of a small business is that, they generally lack a management team. There is an owner-manager and there are worker-
employees. The owner typically experiences all the management functions. So the role of an owner-manager, which is best known as a decision-maker on matters relating to finance, is very significant. S/he is responsible not only for the procurement and distribution of funds but also for the determination of financial policy of a business organisation within the framework of the fiscal policy.

The finance function primarily includes the selection of projects for investment, identification of the probable sources of funds with an eye on maximum return at minimum cost, determination of how to proceed with the funds for investing in the project and how to spend cash efficiently bringing desired results in favour of the owner. The owner-manager then determines the requirements and sources of working capital. It also includes the checking and controlling of financial activities in the enterprise with the help of different strategic tools. As a monetary interpreter of different activities, the tools of financial management analyses the efficiency of different sections, the performance of different personnel and the utilization of capacity and then report for definite action.

The new developments in economic and financial management theories, appear to have been based on the assumption that the relevant unit of analysis is a large, publicly quoted firm which has ready access to external capital market for equity and debt finance. It is normally assumed that the
firm's shares are frequently traded ....... And that the capital market is efficient in processing this information and pricing the firm stock (Keasey and Watson, 1993). Few if any of these features are in fact characteristic of the small business sector and therefore, the financial models and tools will need to be greatly modified if they are to be of any real relevance in increasing our understanding of this sector of the economy.

5.3. Information Economics for Small Business:

Modern era is termed as information age. Individuals, groups, formal or informal organisation etc. produce effective behaviour, if the respective entities can process the information, efficiently (Rao and Pramanik, 1996). Information processing is, therefore, an integral part of any organisation. It is relevant to explore the potentialities of the organisations to process the information. So, ability to process the acquired information of the organisation (formal/informal) determines its extent to exploit opportunities. These opportunities are produced because of the obsolescence of existing knowledge (Rao and Pramanik, 1996).

'Information', and need to optimise 'information processing ability' exist so long as opportunities remain and become a part of uncertain environmental contingencies. Modern organisations (small/large), therefore, strive to enhance respective information processing abilities.
Generally information is identified from the raw data. Data is the subjective or objective recording of any of the trail or qualities of any event or phenomenon which stimulates attention. Specifically, facts, figures, observations, etc. comes under the category of data. These are, therefore, the prime sources of opportunities. It is the information which increases the probability of utilisation of the data by imparting operational classification and cognitive interpretation of the same through a process of metamorphosis which is, in other way, known as decision-making (Sengupta and Kumar, 1996). Through, decision-making, new information is always produced, having higher utility values than the raw data. Information, precisely then, is that part of the classified and interpreted data which definitely brings productive utilisation of the prime data set through cognitive process of decision-making. Here, the role of the man (owner manager) is vital because, the individual not only produces effective information by minimising the errors but also increases his accessibility to information. The individual (owner manager of a small business) alone opts to effective decisions through the application of individual information processing ability, which is very important in proper decision making.

The management of the modern organisation (small or large) needs the steady flow of information in the context of rapidly changing scenario of the environment, affecting the size and functions of the respective organisations
in relation to time. It appears that organisations now perceive the utility of information in the presence of increasing complexities of decision-making and management control.

Therefore, the target of good and vital information system, is to incite and develop a process of decision-making in a most productive way within the organisation so that it can exploit opportunities, arising out of uncertain contingencies of the environment by minimising the gap between ultimate and actual information through a study flow of the same in a way which fulfills the twin goals i.e. profit maximisation in the short-run and social co-ordination in the long prospective (Rao and Pramanik, 1996). In this sense, information system generally expands its functional domains to ensure a continuous flow of information from within and outside the organisation, which, if absent, may produce functional catastrophe to the organisation, jeopardising its survival.

To perform its role in an organisation effectively, information has to be perceived to possess a number of characteristics – it has to be seen as credible, reliable, relevant and timely. However, many of the information produced in the course of economic activity do not possess these characteristics. Even information produced explicitly for monitoring purposes may be seriously deficient in terms of one or more of the desired attributes. This is largely because information is an economic good that is
often asymmetrically distributed, costly to produce, verify and analysis and which may be used in ways which are not perceived to be in the interest, of the party which possess the information and/or has a responsibility to disclose it (Keasey and Watson, 1993).

Information can be classified into two: (a) Formal
(b) Informal.

Formal information is that which is regularly gathered and disseminated within the organisation to help the management in decision making. Informal information is all the other knowledge acquired by personnel which enables them to do their job effectively but of which there is no written evidence. In a big organisation the formal information will be very extensive in order that the different decision-makers can be kept in the picture. In a very small business organisation with one-decision maker, generally information are kept in informal way i.e. economic record, are not kept in black and white.

But, the small business owner-manager is perhaps in a better position to acquire most of the information and can identify the cost of information.

Some of the specific causes which demand the development of systematic information flow in an organisation are:

(a) Proper planning and control of the organisation through informed decision making.
(b) Proper manpower planning and management.
(c) Product development and cost control.
(d) Proper financial administration.
(e) Proper production management.
(f) Wage and salary administration.
(g) Establishment of systematic management control.
(h) Fulfillment of legal, political and economic requirements.

Therefore, an organisation (small or large) can not ignore the importance of information more particularly financial information, because effective functioning, in terms of good financial health, requires the efficient utilisation of the information with respect of time, cost and purpose. Thus, an efficient organisation is one, which can use information by keeping a balance among above dimensions. To this end, information to the organisation resembles the "flow of blood in a biological system, having a network of nerves and veins".

Small Business unit are generally owned and controlled by a single individual and limited liability did not exist, the owner-manager would have every incentive to apply the correct, utility maximizing decisions. This is because, he or she would personally bear all the costs associated with any mistakes and also be the sole beneficiary of any increase in the value of
wealth. In the context of small business owned by single individual (owner – manager), information (financial in nature) serves two main purposes. First at the initial stage it leads to the reduction of uncertainty (adverse selection) and second, after enter into business, information (financial in nature) can reduce moral hazard and uncertainties. Therefore, financial information can lead to better informed decisions since it helps the decision-maker (owner-manager) and improve action choices.

Small Business organisation engaged in economic activity generates a vast amount of potentially useful information. In order to determine the extent of the information available to the small business owner-manager, it is necessary not only to document business records but also to determine what the owner-manager know about their own business irrespective of whether or not it is formally recorded.

5.4. Accounting as an Information System:

In the literature, it is generally agreed that the financial control system exists to ensure that the economic resources of the enterprise are used effectively in the pursuit of agreed objectives. It is an information system, which has a structure or set of procedures which govern the planning and control of resources. To keep in touch with financial condition on a day-to-day basis the owner-manager of a small business requires accounting
information that is accurate, properly organised and continually up to date. A good accounting system must be comprehensive enough to satisfy the purpose of financial control. So there is a close relationship between good accounting and business success. Financial decision based upon inadequate, unreliable or confusing accounting information often lead to financial disaster.

In the year 1970, the AICPA of the USA defined accounting with reference to the concept of ‘Information’:

‘Accounting is a service activity. Its function is to provide quantitative information primarily financial in nature about economic activities that is intended to be useful in making economic decisions’. The modern accounting therefore, is not merely concerned with the record-keeping but also is concerned with a whole range of activities involving:

(a) Planning (b) Control (c) Decision making (d) Problem solving (e) Performance measurement and evaluation (f) Co-ordinating and directing (g) Auditing (h) Tax determination and Planning. (i) Cost accounting (j) Management Accounting. Therefore, today’s accounting focuses on the ultimate needs of those who use accounting information, whether these users are insiders or outsiders.

Many research studies and literature on financial management has proved that there is a close relationship between good accounting practices...
and business success. To keep in touch with financial conditions on a day-to-day basis requires accounting information that is accurate, properly organised and continually up to date. A good accounting system must be comprehensive enough to satisfy the purpose of financial control (Stegall, et al. 1994). Entrepreneurs often blame their failures on low sales revenues, the wrong mix of inventory, high operation expenses, insufficient cash, or too much money tied up in fixed assets. Yet, with a well-designed accounting system, an entrepreneur can spot these problems early and head them off. Accounting figures are the compass readings that show the pilot of the shop of business the speed and direction in which the firm is travelling (Harmon, 1979).

Accounting has been described succinctly and accurately as "the measurement and communication of financial and economic data". The accounting is the major channel through which quantitative information
flows to management (Lynch and Williamson, 1994). Accounting records have always been important because they provide the owner-manager with a sense of direction and tools for control. (Harmon, 1979). Accounting Records is even more important today. It provides the owner-manager with the following information of the business:

1. A system to measure profitability and performance.
2. Data upon which to base forecasts.
3. Information for Government reports/taxes and licenses.
4. Evidence that a firm has paid its dues (bills) and other data used to disprove fraud or claims against the business.
5. Financial data necessary to show value of the firm, if the owner-manager wants to take loan from financial institution or wish to sell it.
6. Data necessary to collect accounts receivable.
7. Information to prepare pay roll and bonus plan for employees.
8. On the basis of accounting information future capital expenditure plans are prepared.

Therefore, Accounting is frequently seen as centrally concerned with the provision of information for decision-making. This was the basis of the
American Accounting Association’s (AAA) definition that accounting is “the process of identifying, measuring and communicating economic information to permit informed judgements and decision by users of the information”. Accounting information are seen as objective truth about the enterprise and are carefully gathered so that they are comprehensive, valid and reliable. They are selected on the basis of their relevance to particular decision, are processed through the application of universally established accounting methods/techniques/rules and presented to decision-maker as the necessary information from which decision will flow. Accounting information is rational because it deals with facts rather than opinions, prejudices or guesses.

A business organisation is regarded as an open system which has a dynamic interplay with its environment from which it draws resources and to which it consigns its products and services. (Das, Sinha, et. al. 1999).

Accounting comprises a series of activities which are inter-linked.
They with observing, collecting, recording, analysing and finally communicating the observed information to its users. Accounting system has three distinct activities viz. (1) Inputs (2) Processing of inputs and (3) Outputs.

Business transaction take place in the regular business activities collected and recorded are called raw data or accounting inputs. These accounting inputs are then processed through classifying, summarising, analysing and interpreting by using different techniques of accounting. This work on the accounting inputs is known as accounting process. These processed data are stored until they are needed.

The processed data/inputs known as accounting output which become information, is then communicated to the users and decision-makers. As we considered accounting as an information system, it establishes a link among the sources of information, a channel of communication and a set of receivers. Here the source of information means the books of accounts which are the repository of accounting data to be needed by different users, channel of information indicates financial statements and reports which contain a pragmatic massage/observation and users indicate all persons or organisations who are interested in the affairs of the business.
Accounting information is required by various users – both internal as well as external. Broadly, the functions of accounting information can be stated as under:

- **Score-Board**: Record keeping is the primary function of accounting. It is the scoreboard of the result of various transactions and gives information regarding profits or losses, expenses or revenues, assets or liabilities. As a score-board, it also maintains data in relation to ‘norms’ or ‘predetermined standards’ and thereby enables a comparison of actual data with standards or judge the health of an enterprise.

- **Store-house of accounting and other economic information**: Accounting information in an enterprise records all the information in monetary terms and the information can be made use of various purposes.

- **Attention direction**: Accounting information is needed by the decision makers to focus on deviations from the planned objectives or the budget or standards and to take correct actions.

- **Problem solving**: Accounting provides information for problem solving. Management is very often confronted with a number of problems and has to take decisions to solve these problems. Accounting information enables the manager to quantify different
alternative solutions to the problem with the relative merits and
demerits of each alternatives.

The administrative function of management develops from its
economic function. The main function of management in an organisation is
to plan, organise and control. Each of these activities encompasses a large
number of complex and interrelated day-to-day actions. In a going concern,
these activities are carried on simultaneously. These three (planning,
organising and controlling) administrative activities have one thing in
common. Each requires that decisions be made. What ever their form or
impact, all decisions have two characteristics in common:

(i) They involve choosing among available alternatives.

(ii) They culminate in action from which certain consequence flow.

Because a decision involves choosing, it follows that some rational
activity has preceded it. The decision maker (i.e. management/owner-
manager in small business) chooses what he perceives to be the greatest
'good' in a given situation. Here lies the importance of accounting
information as accounting has been described succinctly and accurately on
"the measurement and communication of financial and economic data". The
accounting is the major channel through which quantitative information
flows to management. Through accounting information, the owner-
manager/management first decide what is relevant and what is irrelevant and rank the relevant according to its degree of importance to management.

Thus it is, clear that accounting is more than ‘reporter’ or information collector, but it interpret the acquired information or accounting data’s as a ‘editor’ (Lynch and Williamson, 1994). In this way, accounting information is able to influence the decision-makers toward achieving better results.

It may be concluded that accounting as an information system is very crucial for several disciplines which supplement the business operation (Sikidar and Nath, 2002).

5.5. The Basic Financial Records for a Small Business:

A business must record every financial transaction. Records have always been important because they provide the manufacturer / merchant with a sense of direction and tools for control. The financial records of a business begin with the documents that indicate the business transactions as they take place, which includes such things as sales receipts, cash received, purchase orders, invoices, monthly statements from supplies etc. Thus, every financial transaction regardless of how informal, should produce some sort of written record.
The data to record include:

- Sales orders received
- Invoices issued by the business for sales
- Purchase orders placed by the business
- Invoices received by the business for purchases
- Cash receipts
- Cash expenditure
- Account receivable / payable

Not all of these records apply to all businesses. For example, some service firms do not carry inventory and maintains no inventory records. Similarly, not all business extends credit to customers; therefore, an accounts receivable record would not be needed. A general record keeping system for a small business should include at least the following accounting records for financial decision making.

1. **Accounts Receivable**: Records of receivables are vital not only to decisions on credit extension but also to accurate billing and to maintenance of good customer relations. Analysis of these records reveals the degree of effectiveness of the firm’s / business credit and collection policies.
2. **Accounts Payable**: Records of liabilities shows what the business / firm owes, facilitate the taking of cash discounts and allow payments to be made when due.

3. **Inventory Records**: Adequate records are essential to the control and security of inventory items. In addition, they supply information to the business in purchasing, maintenance if adequate stock level and computation of turnover ratios.

4. **Cash Records**: Carefully maintained records showing all receipts and disbursements are necessary to safeguard cash. They yield a knowledge of cash flow and balances on hand in a particular point of time, such information is essential for the proper timing of loans and for assurance of cash to pay obligations.

5. **Other Records**: Among other accounting records which are vital to the efficient operation of the small business are the payroll records which show the total payments to employees; records covering the firm’s investments outside its business, computation of cost of sales / cost of production and services, Drawing / withdraws by the owner–manager for personal use, etc.
These data will enable the business to prepare:

- Production schedules
- Purchasing requirements
- Profitability and efficiency
- Liquidity and solvency
- Stock level of raw materials, work in progress and finished goods.
- Age of debtors
- Age of creditors
- Cost of production and proper pricing.

All the financial information of a business is derived from the bookkeeping systems. While some of the techniques of book-keeping may appear more appropriate for larger business, they will also help very small business as well. Whatever record-keeping system the small business owner—manager chooses, it should follow the following criteria:

- **Simple to use**: Unless a record-keeping systems is simple to use, the owner, who usually is pressed for time, probably will disregard it.

- **Easy to understand**: The system must be so clear that everyone who uses it can understand the information it presents.
• **Reliable**: The record-keeping system adopted by the small business, must perform the functions it is designed to perform and measure the aspects of the business it is needed to measure.

• **Accurate**: Financial Management can be only as accurate as the records and reports used. Faulty information leads to faulty managerial decisions.

• **Consistent**: The system must parallel the operation of the business and should reflect the firm’s financial status consistently over time.

• **Designed to provide timely information**: To make sound day-to-day managerial and financial decisions, the owner-manager of a small business requires up-to-date information.

Just as a homebuilder first lay the foundation, do the framing, put up the walls and then do the finish work. A small business owner-manager also must proceed step-by-step. In the early stage of a business, the most cost-effective method of book-keeping is to keep the books manually. The actual frame of records can be linked to General Records. They are the underlying materials without which there could be no walls. In the same way, General Records of every business transactions are the basis (source of information) for forming Financial statements.
Accounting records are not only the books used to record the business transactions but it also includes all the invoices both issued and received by the business. The business should file its records in an orderly manner, including purchase invoices and sales invoices, as this will assist in keeping accurate accounting records and ready reference.
5.6. Typical Financial Statements:

The preparation of Financial Statements is made possible by the existence of accurate and thorough accounting records. Three most important financial statements are:

a) The Income Statement

b) The Balance Sheet.

c) The Cash Flow Statement.

The Business's most vital Financial Statements

<table>
<thead>
<tr>
<th>Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement</td>
</tr>
<tr>
<td>(Profit &amp; Loss Account)</td>
</tr>
<tr>
<td>• How efficiently is the business run?</td>
</tr>
<tr>
<td>• How profitable is the venture?</td>
</tr>
<tr>
<td>Balance Sheet</td>
</tr>
<tr>
<td>• Is the business venture soundly financed?</td>
</tr>
<tr>
<td>• What is the venture worth at least on paper?</td>
</tr>
<tr>
<td>Cash Flow Statement</td>
</tr>
<tr>
<td>• Will the cash be there when bills / creditors fall due?</td>
</tr>
<tr>
<td>• How much more cash does the venture need to meet sales forecasts?</td>
</tr>
</tbody>
</table>

(a) Income Statement: The Income Statement shows the results of the firm/business operations over a period of time, usually one year. The income statement tells entrepreneurs (owner-manager), how well they are doing that is whether they have earned a profit or not. Because profit is largely a measure of customer satisfaction.
In its simplest form, an income statement looks like as follows:

**Income Statement of a Service Unit**
(Computer Programmer (DTP Operator) for one year)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenues</td>
<td>Rs. 24,000.00</td>
</tr>
<tr>
<td>Less: Operating expenses</td>
<td>Rs. 18,000.00</td>
</tr>
<tr>
<td>Therefore, Operating Profit</td>
<td>Rs. 6,000.00</td>
</tr>
</tbody>
</table>

From the above example, it can be observed that profit is what remains after operation expenses have been deducted from sales revenues; profit, then, is the net effect of two opposing flows of money.

- Money flowing into the business/firm from sales made to customers, either for cash or on credit (generally called sales revenues)

- Money flowing out of the business from costs earned in connection with making those sales (generally called operating expenses).

The example cited above is typical only for service industry/business; which do not sell products that customers can touch and see. For industry groups that do – retailing, wholesaling and manufacturing – the income statement also include an item called cost of goods sold, as following example:

126
### Income Statement of a Retailer/Whole seller/Manufacturer

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenues</td>
<td>Rs. 24,000.00</td>
</tr>
<tr>
<td>Less. Cost of goods sold</td>
<td>Rs. 15,000.00</td>
</tr>
<tr>
<td>Gross profit</td>
<td>Rs. 9,000.00</td>
</tr>
<tr>
<td>Less. Operating Expenses</td>
<td>Rs. 3,000.00</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>Rs. 6,000.00</td>
</tr>
</tbody>
</table>

For retailers, the cost of goods sold generally represents what they paid to whole-sellers for the products they resold to customers. For wholesalers, it represents what they paid manufacturers for the products, they resold to retailers. And for manufacturers, it represents, for those products sold to customers, the cost of converting raw materials into finished products plus the cost of raw materials.

Income statement or the Trading and Profit and Loss Account describes how the assets have been used to generate profit and how that profit was used. The calculation of profit of a business unit is a matter of "judgement": in the estimated life of the fixed asset and in the amount of depreciation to write off each year, underlines an important judgement. There are other areas where judgement is exercised in deciding on profit. Judgement is required when a business will know that some of the debtors (account receivable) will not eventually pay up and therefore will not show these debtors in the balance-sheet or will set up a 'provision' in case the debts are not paid. Similarly judgements regarding the quality and quantity
of stock must also be made and some old damaged or useless stock might not
be shown in the balance sheet or, again, a 'provision' might be set up in case
the stock proves unsaleable.

**Business Transactions and their relationship in the Balance-sheet and
Income statement**

![Diagram showing Business Transactions and their relationship in the Balance-sheet and Income statement]

Source: Dewhurst and Burns (1983).

The point is that financial measurement is not exact. Profit is the result
of certain judgements that people make and therefore, it is an estimate of the
growth of assets through trading, not an exact calculation of it (Dewhurst
and Burns, 1983). Certain accounting principles have developed to help accountants in this area of judgement.

(b) The Balance Sheet: Just as the income statement summarises how well a business venture has done over time, the balance sheet summarises its financial health as of a particular point of time. The balance sheet tells entrepreneurs (owner-manager of a small business):

- What their business venture is worth, at least on paper.
- What they have invested in assets, such as inventories, Land and Building, Plant and Machineries.
- How the assets were financed – that is, where the money came from to buy them.
- Who has what claims against the assets.

The balance sheet is built on the fundamental accounting equation:

\[ \text{Assets} = \text{Liabilities} + \text{Capital}. \]

Any increase or decrease on one side of the equation must be effect by an equal increase or decrease on the other side; hence the name balance sheet.
The first section of the balance sheet lists the firm’s assets and shows the total value of everything the business owns. Current assets consist of cash and items to be converted into cash within one year, such as account receivable and inventory and fixed assets are those acquired for long-term use in the business. Intangible assets include items that, although valuable, do not have tangible value, such as goodwill, copyrights trade marks, and patents – also treated as an asset in a business.

**Balance Sheet as on 1/1/2003**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash/Bank</td>
<td>40,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing Stock</td>
<td>20,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debtors</td>
<td>5,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>65,000.00</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank loan</td>
<td>30,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital (owners equity)</td>
<td>30,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Creditor</td>
<td>5,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>65,000.00</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The second section shows the business's liabilities – the creditor's claims against the business assets. Current liabilities are those debts that must be paid within one year and long-term liabilities are those that come due after one year. This section of the balance sheet also shows the owner's equity, the value of the owner's investment in the business. Once the business starts making profits it will plough back some of these profits. Many terms are used for these, such as 'Reserves', "Retained earnings" 'Undistributed profit', 'accumulated profit', 'Profit and loss account'. All this represents is the funds that the business has retained itself. Those funds could take the form of cash or more stock or more fixed assets or indeed any asset.

(c) **Cash Flow Statement**: This statement indicates the new wealth that has been available to a business in the year and how it has been invested in the business. They can be constructed to highlight changes in the firm's/business's cash position. They emphasize different aspects of management of finance.

To prepare the statement, the balance sheets and the income statements summarising the present year's operations must be assembled. Then the sources of funds – net income, borrowed funds, owner's contributions, etc. are listed. Next the uses of these funds are listed: plant and equipment purchases, profit distributed, repayment of debt and so on.
Cash Flow Statement is vital in forward planning and it is obligatory for all business to publish a cash flow statement showing the source of funds and their use (FRS 1).

<table>
<thead>
<tr>
<th>The main source of Funds</th>
<th>Uses or application of funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Capital introduced by owner</td>
<td>* Owner’s withdrawals.</td>
</tr>
<tr>
<td>* Loans to business</td>
<td>* Loan repayments.</td>
</tr>
<tr>
<td>* Sale of assets</td>
<td>* Purchase of assets.</td>
</tr>
<tr>
<td>* Income from operation</td>
<td>* Losses from operation.</td>
</tr>
<tr>
<td></td>
<td>* Payments to tax authorities.</td>
</tr>
</tbody>
</table>

The difference between the total sources and the total uses is the increase or decrease in working capital. Surplus or shortfalls are noted in the reconciliation of opening and closing balance. By investigating the changes in the firm’s working capital and the reasons for them, owners-managers of small businesses can create a more practical financial plan of action for the future of the enterprise. They can also help small business managers map the firms/business’s financial future and actively plan for profit. Cash flow statements are now required in financial reports because success depends on maximising the flow of cash throughout the year.
Circular flow of funds showing sources and applications of funds/cash.

**INTERNAL FLOW OF CASH**
- Finished goods
- Work in progress (Material, labours, Expenses)
- Creditor
- Capital Investment on fixed Assets
- Credit Sales
- Cash Sales
- Debtors (goods and services)

**CASH POOL**
- Loans from Bank
- Overdraft
- New capital introduced.
- Loan Capital
- Taxes
- Dividends / Profit
- Repayment of Capital
- Repayment of Loans

**External Flow of Cash**

Source: Modern Business Administration (1994).
Mere preparation of these statements, i.e. (a) Profit and Loss a/c, (b) Balance sheet and (c) Cash flow statement, is not enough; owner-manager must understand and use the information contained in them. These data are critical to the success and the ultimate survival of the business.

5.7. Tools of Financial Management:

In performing the responsibilities and duties more effectively and efficiently, the owner-manager of a small business may take the assistance of various techniques of financial management. Amongst the various techniques of financial management, most commonly used techniques are analysis of financial statements, Ratio Analysis, Cash Budgeting, Cost-volume Profit analysis and Capital Budgeting.

(i) Income Statements: Financial analysis comprises the various financial statement items according to some logical criteria. This statement comprises the balance sheet and the profit and loss Account or income statement. This two statements are the very important means by which a business firm can be viewed in its entirely as they represents the whole firm’s activities/performance from different aspects.

Financial Analysis is required by outside suppliers of capital, creditors and investors and also by the firm itself. The type of analysis varies according to the specific interest of a party. A trade creditor is interested in
the liquidity of the firm. An Investor is mainly with its present and expected future earnings and the stability of these earnings in the long run. And the internal management is interested in showing the outside creditors and investor or financiers a better financial position and sound operating ability of the firm through the analysis of the financial statements. Moreover, for internal control it is a must at regular intervals (Sen, Jain and Bala, 2002).

(ii) Cash Budget/Budgeting: Budget is nothing but a financial plan of the enterprise over a short and a long period of time. A cash budget is the forecast of future cash receipts and cash disbursements over various intervals of time. It reveals to the management, the timing and amount of expected cash flows and outflows over the period under study. With its information, an owner-manager is better equipped to determine the future cash needs of the business, plan for the financing of these needs and exercise control over the cash and liquidity of the firm.

The preparation of cash budget involves the following steps: (monthly cash budget)

1. Estimate monthly receipts assuming no additional financing;
2. Estimate monthly expenditures;
3. Comparison between the monthly receipts and expenditures assuming no additional financing.
4. Estimating cash balances to be available at the month assuming no additional financing.

5. Forecasting the fluctuations in cash inflows and outflows and determination of the extent of a ‘cash-cushion’ to be built up for meeting such derivations.

(iii) Cost-Volume-Profit (CVP) Analysis: CVP analysis is a Financial Management tool, which can be very effectively used in planning and control activities of business enterprise. It provides the measuring devices and needs only the master’s touch to produce the right mixture (Sen, Jain and Bala, 2002).

In planning, CVP Analysis can be used to determine whether efforts would be better directed towards the reduction of fixed and variable costs. It can be used to arrive at decisions involving the interaction of selling prices and sales volume. It provides the only sound basis for predicting profits and can point out where sales efforts should be directed/emphasised. Therefore, it is a means of evaluating sales performance.

As a control device, CVP analysis can be used to detect the insidious upward creep of costs that might otherwise, go unnoticed. It reveals whether actual performances were as profitable as they should have been (Sen, et. al. 2002). In analysing performances, it is far superior to percentage comparisons that mislead as often as they inform. The tool of cost-volume-
profit Analysis, which is popularly known as break-even analysis, reflects, the whole position usually with the help of a break-even-chart.

The break-even point found out through the analysis gives a situation, below which point production or turnover is undesirable. Basing on this analysis, different costs can be adjusted and efforts may be generated for striking a balance between the cost, volume and profit of the business. Mathematical calculation of the break-even point is done with the help of the following formula:

Break-Even Point (volume in units)

\[
\text{BEP} = \frac{\text{Total fixed costs (F)}}{\text{Selling price per unit (P)} - \text{Variable cost per unit (V)}}
\]

The Break-Even Point can also be calculated for Break-even Sales Volume (expressed in monetary value) which is \( F/CMR \), where CMR represents 'contribution margin ratio' \( = (P-V)/P \) or \( P/V \) ratio \( = \Delta P/\Delta V \)

(iv) **Ratios Analysis**: Financial statements are interpreted (analysed) by calculating certain ratio. Ratios show the relationship between two items. Ratios are the tools with which business can measure performance and are used in the analysis of financial statements because a business owner-manager might be misled by a comparison of money figures alone.
Financial ratios can be used in the determination of policies for future operation of the business in two ways. First, business owners may find it helpful to compare their firm’s ratios for the period under scrutiny with similar ratios for the previous periods/years. Such comparison can often help to pinpoint conditions in their business that merit attention.

Second, business owners can compare the ratios for their business with the standard ratios in their industry/sector of business. Standard ratios are averages of the results achieved by thousands of firms in the same line of business.

There are four main types of ratios that may be used in examining the financial health of a business enterprise:

1. Profitability Ratios, which measure the firm’s earnings in relation to sales and investment.

2. Liquidity Ratio, which indicate the firm’s ability to pay its bills/dues as they become due.

3. Turnover Ratio, which measures how effectively the firm uses its resources to generate sales or profit.

4. Leverage Ratio, which measure the firm’s debt load.
### Computing Financial Ratios Measuring a Business's Financial Health

#### I PROFITABILITY RATIOS:

<table>
<thead>
<tr>
<th>Numerator</th>
<th>Denominator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Margin Ratio</td>
<td>Net Sales</td>
</tr>
<tr>
<td>Net Profit Ratio</td>
<td>Net Sales</td>
</tr>
<tr>
<td></td>
<td>or</td>
</tr>
<tr>
<td></td>
<td>Net Profit</td>
</tr>
<tr>
<td></td>
<td>Average tangible net worth</td>
</tr>
</tbody>
</table>

#### II LIQUIDITY RATIOS:

<table>
<thead>
<tr>
<th>Numerator</th>
<th>Denominator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Ratio</td>
<td>Current Liabilities</td>
</tr>
<tr>
<td>Acid-Test Ratio</td>
<td>Current Liabilities</td>
</tr>
<tr>
<td></td>
<td>- (Inventories)</td>
</tr>
</tbody>
</table>

#### III TURNOVER RATIO:

<table>
<thead>
<tr>
<th>Numerator</th>
<th>Denominator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital turnover ratio</td>
<td>Net sales</td>
</tr>
<tr>
<td>Investment capital turnover ratio</td>
<td>Fixed Assets</td>
</tr>
<tr>
<td>Inventory turnover Ratio</td>
<td>Cost of goods sold</td>
</tr>
<tr>
<td></td>
<td>or</td>
</tr>
<tr>
<td></td>
<td>Net Sales</td>
</tr>
<tr>
<td></td>
<td>Average inventory at cost.</td>
</tr>
<tr>
<td></td>
<td>or</td>
</tr>
<tr>
<td></td>
<td>Net Sales</td>
</tr>
<tr>
<td></td>
<td>Average inventory at retail.</td>
</tr>
</tbody>
</table>

* Receivables turnover Ratio:

  - Average daily credit sales
  - Average collection period

#### IV LEVERAGE RATIOS:

<table>
<thead>
<tr>
<th>Numerator</th>
<th>Denominator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt-Equity Ratio</td>
<td>Tangible Net Worth</td>
</tr>
<tr>
<td></td>
<td>+ Fixed liabilities</td>
</tr>
<tr>
<td>Fixed debt load</td>
<td>Fixed Assets.</td>
</tr>
</tbody>
</table>
Capital Budgeting: Capital budgeting may be defined as the formal planning of the sources of long-term funds and their allocation among potential long-term uses. This process involves one of the important functions of financial management. Owner-manager of a business has to take a judicious decision on the investment of the available funds in the desirable projects. This decision is most important because, it involves a huge sum of money and its effects will be felt for a long period of time. Another important aspect of the major investment decision is that until such decision is made and implemented many other related decisions cannot be undertaken. Therefore, it shows that, decisions reached through the process of capital budgeting are of extreme importance to the long-term success of a business enterprise.

Capital budgeting involves the generation of investment proposals, the estimate of cash flows for the future capital investment proposals, the evaluation of cash flows and the selection of projects based upon an acceptance criterion. Capital investment decision involves the measuring of investment worth of a proposal. The methods of measuring are:

1. Payback Period Method

2. Average Rate of Return

3. Discounted cash flow Method:
   (a) Internal Rate of Return (IRR)
(b) Net Present Value Method (NPV)

(c) Profitability Index.

1. **Payback Method**:

   This method indicates the time to be required to recover the original investment and is usually expressed in terms of years. Payback Period is calculated by using the formula:

   \[
   \text{Payback Period} = \frac{\text{Net cash outlay (NCO)}}{\text{Annual net cash benefits (NCB)}}
   \]

   If this method is used for evaluating a series of competing investment proposals, the project which has the shortest payback period is accepted.

2. **Average Rate of Return Method**:

   It is an accounting method and represents the ratio of the average annual profits after taxes to the initial investment. The rate is arrived at by using the following formula:

   \[
   \text{Average Rate of Return} = \frac{\text{Average annual NCB} \times 100\%}{\text{Net investment (NCO)}}
   \]

   Where; \( \text{NCB} = \text{Net cash benefit} \)

   \( \text{NCO} = \text{Net cash outlay} \)

   *The project which yields a higher rate of return is normally accepted.*
3. **Discounted cash flow Method**:

According to this method, the cash outflow (Net capital investment) and the expected cash inflows of the investment are discounted at an appropriate cost of capital to their present values. The present values can then be analysed to determine the suitability of the project.

The Discounted Cash flow technique includes the following methods:

(a) **Internal Rate of Return (IRR)**:

IRR for an investment proposal is defined as that discounted rate which, when applied to a series of future NCB, (Net cash benefit) marks the present value of NCBs equal to the present value of the NCO (Net cash outlay) necessary to generate them. IRR is then compared to a required rate of return and if it exceeds the required rate the project is accepted.

(b) **Net Present Value Method (NPV)**:

NPV is the present value of net cash benefits discounted at the appropriate cost of capital minus the NCO (Net cash outflow). Under this method, the present value of the expected net cash benefits of an investment is ascertained by discounting at the cost of capital and subtracting from it the net cash outlay of the project. If the NPV is positive, the project is accepted; if negative, it is rejected.
(c) Profitability Index (PI):

This method places all projects on the same comparable basis. If the PI for a given project is greater than 100, the project is accepted. The formula for calculating the Profitability Index (PI) is:

\[
PI = \frac{\text{Gross Present Value of NCB} \times 100\%}{\text{Present Value of NCO}}
\]

Where,

NCB = Net Cash benefit

NCO = Net cash outflow.

5.8. Elements of Cost and Price:

Many business establishments have difficulty in calculating the cost of their products or services and as a result, let their competitor get the weaknesses and set their price. As mentioned in all the financial management books, profit is the relatively small difference between the two relatively large numbers of sales revenue and expenditure. A small change in any one of those can cause a large change in profit, so getting both pricing and cost right is clearly very important.

Every business units need to charge a price that will cover all the costs and generate a reasonable profit to stay in the business. It is very important to note that, there is little relationship between costing and pricing. The price
should be the maximum amount that people will pay for business product or services. The cost on the other hand is the cost of a business of making the product or delivering the services. Costing/Cost Accounting methods of financial management aim to allocate costs between jobs and periods. In addition, however, business objectives should always include attempts to reduce costs and to improve productivity. Keeping the price high and the costs low will therefore, maximise profit for the organisation.

It is therefore, very important to know how to spread the costs. It is easy to see all the different costs that a business incurs, but it is often helpful to divide these up.

- **Direct Cost** are those that can be directly attributed (usually measurable) to the production of a particular product or service. Raw materials are direct costs. Sub-contracting is a direct cost. Deducting the direct costs from the sales revenue for a particular product gives its contribution towards over-heads and profit.

- **Variable Cost** are those that vary in proportion to the level of production. These will include for example, raw materials, direct labour and sub-contract work. However, some over-head costs, such as use of electricity, may also vary with total production. Variable cost are also called as marginal costs.
• **Fixed Costs**, on the other hand, do not vary in the short run and are not dependent on the level of production. This includes, for example, rent, rate, insurance and manager’s salary.

• **Indirect Costs** are the opposite of direct costs – those costs that cannot be directly attributed to a specific product. The overheads are indirect, some will vary with the level of production, and some will be fixed. For most small businesses, the overheads can generally be regarded as fixed, at least in the short term.

A manufacturing unit can calculate the cost per item by:

\[
\text{Item Cost} = \frac{\text{Overheads}}{\text{Total items}} + \text{Direct cost per item}
\]

A service based business unit can calculate the cost of services:

If the service provider involves in business’s such as industrial design or software development, etc. then the business will need to know how much to charge per hour, through estimating the total time required. This can be done by:

\[
\text{Hourly Rate} = \frac{\text{Over heads}}{\text{Annual Productive hours}}
\]

Small business owner-manager, must remember that not all working hours will be productive. Some time will be required for promoting the
business, buying supplies, doing the book-keeping work etc. There may be some holidays and should also allow for possible illness.

Some businesses are simply engaged in buying and selling; many of those are particularly retailers, selling an extremely wide range of products. They tend to think about the mark-up required to cover their other overheads. The mark-up is simply the inverse of the Gross Profit margin. Therefore, before establishing a mark-up price, the business need to estimate likely total sales and to know all the overhead expenses/costs. Business margin must still cover all overhead costs, otherwise, the business will not make any profit.

**Pricing Strategies**: The greatest danger for a business (small/large) is to setting a price for their products/services for the first time is to pitch it too low. On the other hand raising a price in the competitive market is always more difficult than lowering one. Therefore, while selecting a price of products/services, the owner-manager of a small business can choose any of the following pricing strategies:

- Cost based pricing - total costs are calculated and a mark up is added to give the required profit.

- Skimming - business may change a relatively high price to recover set up costs quickly if the product is good or new. As more competitors enter the market, producer can lower the price.
• Individual - business unit can negotiate prices individually with customers based on how much the proposed buyer are prepared to buy.

• Loss leaders - if the business wish to sell to a particular market then the business organisation might sell one product or services cheaper to gain market entry. And the organisation can balance these losses by selling other products/services at a higher price. This can be risky, as the danger is that everything becomes a loss leader.

• Expected price - what does the customer expected to pay? If the business organisation are selling a quality product/services, do not underprice. Often the customer expected to pay a lot as the product/services has a certain ‘snob’ value and this may be diminished if the business is underprice.

• Differential pricing - the organisation can change different segments of market/customers different prices for the same service/products.

It is to be mentioned here that, if the cost of a product/services of a business and the price change is much higher than the competitors’ then the organisation will have to look at ways of reducing costs.
Computing the Cost of sales in various Types of Small Business

1. **Trading / Merchandising Establishments**:
   Merchandise inventory, beginning of period (year)
   (+) New purchases during the year.
   (-) Merchandise inventory end of the year
   (=) Cost of goods sold.

2. **Manufacturing Establishments**:
   Raw materials inventory, beginning of period (year)
   (+) Purchases
   (-) Raw materials inventory at the end of the year.
   (=) Raw materials used.
   (+) Direct Labour
   (+) Factory over head (indirect labour, machine and plant depreciation, repairs and maintaining)
   (+) Work in progress inventory, beginning of the period.
   (-) Work in progress inventory, end of the period.
   (=) Cost of manufacturing.
   (+) Finished goods inventory, beginning of period.
   (-) Finished goods inventory, end of the period.
   (=) Cost of goods sold.

3. **Service Business**:
   Spare parts inventory (beginning of the period).
   (-) Purchases
   (-) Spare parts inventory (end of the period)
   (=) Cost of parts (on service supplies)
   (-) Service labour (labour directly cost to individual customers order)
   (-) Cost of merchandise sold, if any.
   (=) Cost of sales.
5.9. Inventory Management:

The management of funds invested in inventory is important because in many cases inventory is the largest single asset, particularly on the current side. Equally important is the fact that inventory is the least liquid current asset; hence errors in management are not readily remedied.

Inventory control is one of the elements of financial management, and carried out successfully can materially increase the profits of the business. It need not be expensive to the small business unit. A small amount spent in setting up and maintaining a system of inventory control may very well disclose hidden losses that would not otherwise be brought to the surface. As it is said that an excessive stock of materials and supplies represents idle working capital – in fact, too much of it means 'dead' capital.

The purpose of controlling inventory is to maintain a stock balance that permits profitable operations with the least cost. The major objectives are as follows:

1. To secure maximum sales by having the goods on hand to meet demand.

2. To protect the inventory from theft, deterioration, rust, decay and destruction.

3. To assure continuous operational flow in manufacturing unit.
4. To minimise the cost of carrying the inventory, including interest on money invested, obsolescence, insurance, taxes and cost of warehousing.

5. To provide records of purchase quantities, order dates and other data essential for evaluation of management performance.

Therefore, Inventory (stores) control as a system of keeping track of the merchandise received and merchandise sold — or in even simpler words, the ‘ins’ and ‘outs’.

It is essential that every class of business have some form of stock book, recording the items coming in and the items going out. Where there are only a few items involved, a notebook page for each item will suffice. But, once the small business unit has discovered the full value of inventory records he will wish to have slightly more elaborate stock books for the permanent history of the business.

There are a number of costs associated with carrying inventory. First, there is the cost of funds invested in inventory and equipment to handle the inventory. Next, there is the cost associated with the space occupied by the inventory, which may include depreciation charges, maintenance charges, rental charge taxes, etc. Then there may be certain inventory service costs, such as taxes and insurance, the labour costs of receiving and stocking, inventory record and book-keeping costs, pilferage costs. Finally, there may be the
costs associated with the risk of a price decline, the risk of a style changes or other causes of obsolescence.

In considering the cost of excess inventory, it is important to recognise those that will vary with the level of the inventory carried and those, which are fixed at least in the short run (Stock) level. The business unit first of all must determine what quantities are most economical to buy. Closely related to this is the question of safety stocks to absorb unexpected fluctuation in inventory availability or sales. Here the owner-manager of a small business has to weight the cost of being out of stock against the cost of maintaining the safety stock. Another important area of inventory management is the lead time necessary in ordering inventory, that is, the time period involved in ordering and receiving delivery.

Let us start, with a very simple illustration of stock recording process for different sector of small business:

(a) **Manufacturer**: The stock (inventory) records of a manufacturing business should be as detailed as possible. Generally the manufacturer has three classes of inventory: Raw materials (which may include component/spare parts or factory supplies); goods in process; and finished goods. As a manufacturer always attempt to determine what quality of raw materials to order and finished goods to stock, they try to seek a balance. Another force advises
the manufacturer to stock raw materials heavily and avoid the risk of running out of stock.

One of the earlier systems designed to strike this balance is called the minimum – maximum formula. It computes a medium between minimum stock required and maximum stock usable. A more precise method for achieving this balance is the formula for Economic Order Quantities (EOQ), which is:

$$EOQ = \sqrt{\frac{2RS}{KC}}$$

Where,
- \(R\) = Annual stock used in units
- \(S\) = Order preparation cost in Rupees.
- \(K\) = Cost of carrying inventory as percentage of inventory.
- \(C\) = Cost per unit.

As to the size of a production run, the small manufacturer can easily apply the following formula for Economic Production Quantities (EPQ), which is:

$$EPQ = \sqrt{\frac{2RC}{K(1 - \frac{r}{p})}}$$

Where,
- \(R\) = Annual units required.
- \(C\) = Cost of setup (of machinery)
- \(K\) = Cost of holding inventory (stock)
- \(r\) = Rate that units are used in time period.
- \(p\) = Rate units are produced in same time period.
(b) **Small Retail Trader**: The typical retailer is an artist in trading and stocking huge quantities and varieties of merchandise. This requires accurate records and frequent observations to control the situation.

There are two kinds of inventory records is Perpetual Inventory Control and Physical count. First Perpetual system as used in Inventory Control means that the balance on hand is shown after every stock record entry. In the following (illustration) of a stock book for Retailer in a tabular form, which includes all such things a dealer needs is a columnar book showing the following information.

### Stock Book in Perpetual Inventory Control System

<table>
<thead>
<tr>
<th>Date</th>
<th>In</th>
<th>Out</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 10. 2004</td>
<td>-</td>
<td>60</td>
<td>270 Nos.</td>
</tr>
<tr>
<td>Jan. 16. 2004</td>
<td>-</td>
<td>100</td>
<td>1080 Nos.</td>
</tr>
<tr>
<td>Etc. to Jan. 31\textsuperscript{st} 2004</td>
<td>-</td>
<td>500</td>
<td>410 Nos.</td>
</tr>
<tr>
<td>Total</td>
<td>1000</td>
<td>1090</td>
<td></td>
</tr>
</tbody>
</table>
In the above illustration a retailer may have the ‘Ins’ which records are obtained from the manufacturers invoices/whole sellers invoices and the ‘outs’ are inserted from a daily total of the sales invoices.

The second type of inventory (stock) control records are those that show the following information about an item in stock through physical count:

1. Description, model number, size/colour etc.
2. Number on hand.
3. Number ordered and received.
4. Number available.
5. Number sold.
6. Number on hand (Balance on hand at the last date).

**Inventory Control Record Card**

<table>
<thead>
<tr>
<th>Date</th>
<th>6/1/04</th>
<th>14/1/04</th>
<th>18/1/04</th>
<th>18/1/04</th>
<th>1/2/04</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
<td>On hand</td>
<td>Ordered</td>
<td>Received</td>
<td>Available</td>
<td>Sold</td>
</tr>
<tr>
<td>BW-4</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>BW-5</td>
<td>6</td>
<td>0</td>
<td>0</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>BW-6</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Totals</td>
<td>11</td>
<td>5</td>
<td>4</td>
<td>15</td>
<td>9</td>
</tr>
</tbody>
</table>
The above illustrated method is not so much a way of controlling inventory as it is a method of adjusting the inventory figure on the books to the physical inventory control at the end of an accounting period. It is simple and saves book-keeping expenses.

(c) Wholesaler: The problem of wholesaler's in inventory control are different from those of the retailer. As wholesalers generally carry much larger inventories and fill order to the manufacturer/producers directly of a greater magnitude. Wholesalers must keep extremely accurate records. Wholesalers do not have to display of merchandise, they do face serious storage problems as yesterday's large empty spaces become overcrowded with today's merchandise.

The typical wholesaler inventory control system provides the same information as the retail system. This, merchandise on hand, on order, order received, sold and stock on hand etc. Other than this detailed record of inventory a wholesalers have to maintain a minimum stock requirement that triggers future buying. Wholesalers may use a tickler file (Hurman, 1979) to remind them when to order and a stock record and renewal form as shown in the following illustration.
### Stock Record and Renewal Form

<table>
<thead>
<tr>
<th>Date</th>
<th>Order No.</th>
<th>Units</th>
<th>Invoice No.</th>
<th>Units</th>
<th>On hand</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/9</td>
<td>0.146</td>
<td>200</td>
<td></td>
<td></td>
<td>216</td>
</tr>
<tr>
<td>16/9</td>
<td>-</td>
<td>-</td>
<td>S. 164</td>
<td>48</td>
<td>168</td>
</tr>
<tr>
<td>17/9</td>
<td>0.149</td>
<td>80</td>
<td>-</td>
<td>-</td>
<td>248</td>
</tr>
<tr>
<td>22/9</td>
<td>0.151</td>
<td>80</td>
<td>-</td>
<td>-</td>
<td>328</td>
</tr>
<tr>
<td>24/9</td>
<td>-</td>
<td>-</td>
<td>S. 181</td>
<td>200</td>
<td>128</td>
</tr>
<tr>
<td>Minimum stock level</td>
<td>200 Units</td>
<td>Recorder Level</td>
<td>40 Units</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

It is very important for all retailers, as wholesalers who run small businesses must carry a supply and the proper assortment of all items to meet any anticipated demands. Otherwise they may lose sales which will ultimately suffer profits. On the other hand, if the business organisation does not have a balanced stock of all the items he sells regularly, a merchant might very well have too much capital tied up in slow moving items. This will seriously affect the business’s ‘stock-turnover’.

There is no possible way for a stock/inventory of any reasonable size to keep control of these important functions, other than by adequate stock records, especially if the maximum and minimum stock requirements are based on several years actual experience (Tungale, 1952). A careful scrutiny of each stock card will give useful information regarding the high and low
movement of each item; how many units are being sold each month, ‘the efficiency with which merchandise is being purchased; and finally, the most valuable information the stock card will give – the items which have been in stock too long.

If all the information caught in time, an over-stock position can be adjusted at a minimum of loss. It is obvious that the later the discovery of such a situation, the greater the potential loss.