UNIT 10 FINANCIAL MANAGEMENT ISSUES IN SSE

Objectives

After going through this unit you should he able to:

- explain the important issues related to financial management in small enterprises,
- discuss conservatism and liquidity management in small enterprises,
- describe issues related to management of assets and liabilities,
- discuss the implication of financial planning for growth.

Structure -

10.1 INTRODUCTION

In this unit we shall discuss a few key issues in financial management. Typically entrepreneurs of small scale enterprises start well, but somewhere down the line, in their day-to-day operations they miss the route to success. In more than half such cases the reasons identified can be attributed to financial mismanagement. At times, such entrepreneurs have a feeling of well being but year end consolidation of accounts indicates a disastrous situation, loss or almost being on the verge of losing. At other times, opportunities come by but cannot be grabbed. Reasons for such inadequacies can be inability to think of sources of funds or rigidity on the part of the banker. The banker's non-cooperation, most often, is due to entrepreneur's inability to maintain accounts and strongly present his case. All such problems can be suitably tackled if, all along, an entrepreneur keeps upper most in his day-to-day operations certain considerations in financial management.

Activity 1

State whether True/False.

1) Financial management is of secondary importance in most small scale enterprises — True/False.

2) Opportunities come and can be grabbed provided one is well-equipped including financially — True/False.

3) A vague feeling of well-being is not necessarily a sure indicator of enterprise success. — True/False.

10.2 BUSINESS SUCCESS OR FAILURE

The **sine qua non** of all business is profits. And, the basic underlying soundness of business governs its health and growth. Loss may be an indicator of business failure and, profits may indicate success in day-to-day business operations. This may not always be so. The surest test of business success would be sufficient and growing profits - profits that are growing from year to year.

An important factor, therefore, is to determine whether the nature of business has the potential to produce profits. There is no point selling a lakh rupees worth of your product if it costs a lakh and quarter to produce it. In the short run, Pack of sufficient cash at the right time has compelled fundamentally sound businesses to fail. Therefore, one must determine not only need for profit but cash as well. The moral of this unit is knowing where, when and how to obtain finance is of limited value if you have little idea how to use it effectively.

The basic soundness of a business can be measured through Breakeven Analysis and the cash needs can be estimated through Cashflow Analysis. These methods provide a balance between accuracy and simplicity. The two analyses should not be taken as mere mathematical or accounting exercises but should be employed as proper planning tools to determine and ensure sound business health.

Profit or loss of a business is usually measured with the help of the annual Profit and Loss Account. This statement, quite often, is prepared five to six months after the year ends. Therefore, the effect of today's decision shall be known seventeen or eighteen months hence. This is too long a period; in as much time much water would have flown down the Ganges and an irreparable damage may have been set in the unit. You should endeavour to prepare the Profit and Loss Account more frequently, say every month, to measure the success of your day-to-day operations and, if just in case there is a loss, take timely corrective action.

Activity 2

Fill in the blanks:

1) Any business is run for …………….
2) Profit is …………………….necessarily a sure indicator of success.
3) Adequate and ……………….profit is a sure indicator of business ……………..
4) The basic soundness and cash needs of a small business can be measured with the help of …………………..analysis and ………………………………..analysis.
5) Profit and Loss Account measures the business ……………….or ……………..

10.3 EVALUATING PERFORMANCE

A successful small business person must not only be `very committed' and `hard working' but also `have a firm sense of direction'. Only then will he be able to guide the business unit to its set goal. To ensure that a business unit is running on its set course would require monitoring and evaluation. The performance of various business activities would be measured by relating output to input. This would require establishment of performance standards. Without a standard there is no logical basis for taking a decision for corrective action. An entrepreneur must have basis for comparison to enable him decide or act.

Such standard can be of two types: **judgement standards** or **engineering standards**. Based on experience standards are set by what has been and a judgement of what they could be. The latter is intuitional or judgemental. Managers and technologists like to improvise standards based on modern techniques, such as operations research, work study etc. To non-technical people "engineering standards" may appear theoretical. Though they may be so they embody the latest scientific techniques and theories. After all, yesterday's practice is today's theory and, today's theory is tomorrow's practice. So also is true of standards. They are revised based on new revelations. However, while setting standards it is desirable that the staff whose performance is required to be measured is consulted and taken into confidence.

Comparing performance with standards is the most critical process in management control. This is called "monitoring". This means "to detect" or "to tap" so as to ensure things are working out as they were originally planned. In actual performance there would be distortions. At times this may be owing to lack of appreciation of such performance standards. This can be arrested by asking for report, oral or written. This also avoids doubts between the giver and the receiver.

Performance standards can even be set based on budgeting. The three major functions of budgeting are planning, motivation and control. Accordingly, Planning Budget, Motivation Budget and Control Budget can be prepared. Planning Budget could be the Operating Budget, Financial Budget or the Projected Income Statement.

Motivation Budgets can be sales quotas or other motivational budgets. Control Budgets are prepared in order to assign responsibility for cost incurrence within the business enterprise so that they are controlled at the point of incurrence. Unlike planning and motivational budgets which are prepared only once, control budgets require preparation on two occasions. First, they are prepared in advance of the activity to indicate what the cost should be. Then at the end of the reporting period, these budgeted costs are adjusted to the actual volume of activity so that they can be compared with the actual cost incurred.

Business performance can even be measured based on ratios. In this case the standards used can be historical, horizontal and budgeted. Historical standards are based on past performance of the business enterprise. Therefore, new enterprise will not have historical standards. New firms can employ budgeted standards which are arrived at after preparing the budget for a set period based on planned performance. While these two standards are internal, horizontal standards are external as they measure the performance of your business enterprise with other firms in similar industry or trade. Both internal and external analyses are important. Internal analysis tells how you have performed compared to the past. But when the external environment turns unfavourable and your business performance declines, is it indicative of your good or bad management? External analysis will now come to your rescue. If your decline in performance is less than the industry average you have not performed so badly.

For performance evaluation to be useful and effective it must be done periodically and regularly. And, it should be followed by suitable corrective action to ensure your SSE runs along the course charted.

Activity 3

1) Explain the significance of performance evaluation for financial management.

2) What could be the different methods to evaluate performance of a small business enterprise?

……………………………………………………………………………………
……………………………………………………………………………………
……………………………………………………………………………………
……………………………………………………………………………………
……………………………………………………………………………………

10.4 PRINCIPLE OF CONSERVATISM

Owing to their high achievement-orientation entrepreneurs are dynamic, optimistic and are usually noticed to be going in for high goal setting. This is reflected in their exercise in planning, budgeting and setting standards. Formulating a project report is an exercise in planning. In project reports the tendency is to indicate a higher value of sales, production and profits in a bid to impress bankers. Such a disposition is not recommended from a good financial management point of view. Sound financial management assumes conservatism.

Conservatism in accounts means that of the many pictures or positions available, the least attractive is presented. The principle is "anticipate no gains or revenue and provide for all possible losses or expenses". It is not to suggest that you go on providing for expenses or losses which would reasonably not occur or ignore revenues which should be reported. This principle is recommended in situations of uncertainty; in situations where a clear-cut decision is not possible usually in issues relating to valuation, classification or timing. It is a guide for unusual situations in which clarity is missing and not a hard and fast rule.

Following the principle of conservatism will save you from awkward situations, save your face and your reputation. Suppose in your project report instead of following the principle of conservatism you indicate the most hopeful sales, production and profits. Eased on these, loans are got sanctioned. But tomorrow, when profit and other projections slip, the entrepreneur will have to cut a sorry figure with his financiers., So also for cash flow forecasts. If one is too optimistic, the slightest downturn in business activity can create situations of cash crunch and subsequent loss of reputation.

In the case of inventory of merchandise one can take the cost price or market price. The convention, based on principle of conservatism, is to take the lower of cost or market value. This is the principle for writing books of accounts or while submitting stock statements to your banker.

In case of fixed assets, particularly land and building, one has the option to reflect the cost price, market value or book value (cost price less depreciation). As per the principles of conservatism reflect the least figure. In case of some banks, the value of buildings owned is reflected in the balance sheet as just Re 1 while the actual value is several crones! This reflects their strength.

Undue optimism can be harmful. Following the principle of conservatism would add intrinsic strength to your financial position and condition. It is far better to be humble than to eat a humble pie.

Activity 4

1) Enumerate the pros and cons of being conservative and optimistic in small business.
2) While valuing stocks the value to be taken should be
   a) Cost price
   b) Market price
   c) Market price including premium especially when the commodity price is controlled.
   d) Lower of (a) and (b).
3) While reflecting the value of land and building as also other fixed assets one should indicate :
   a) the cost price
   b) market value
   c) book value
   d) None of the above

Ans : 2(d) 3(c)

10.5 ASSET MANAGEMENT

The funds raised in a business are invested in various assets. Such investments have associated costs. These could be interest on loans, debentures etc. or opportunity cost in case these funds are owned. If proper care is not taken the costs would go up, profits shall come down and the return on investment would decline. Therefore, analysis and supervision is required at pre-investment stage - that is, before the assets are purchased - and at the post-investment stage - that is, after the assets have been purchased. To maximise return on investment every business firm should endeavour to ensure maximum utilisation of each and every asset. Here, we shall discuss management aspects of only those assets where pitfalls are commonly observed in the daily operations of a small business.

Land and Building

A new business firm would do well to start operations in a rented premises rather than owned premises. In big cities entrepreneurs usually prefer to go in for owned premises as their value appreciates fast. This is not advisable for a new enterprise as a substantial portion of the total project cost - usually 25 to 30% - gets locked up. Such funds are interest bearing; own land and building invites a variety of rates and taxes, may be even wealth tax. Then there is cost of repair, maintenance and depreciation of building. All told rent of as big a premise normally works out lower than total of all recurring costs likely to incurred on own buildings. To that extent one can earn more profits. When funds to be invested in land and building are your own, there is opportunity cost associated.

In any business there are opportunities that constantly keep coming your way. If funds are available they can be grabbed and extra profits earned. On the other hand, if funds are locked up in owning land and building one may not have funds to grab a large order or make use of extra discounts a supplier may offer on goods and services.

Finally, owning land and building increases total debt. This increases debt-servicing liability. With less profit, chances of default in debt servicing (paying interest, instalment etc.) are more. The appreciation in value of land and building is also meaningless for a going concern unless you are thinking of winding up the business

You may think of going in for own land and building only after business is established for a few years and operations are established.

Trade Debts

Trade debts or bills receivables are extended by small enterprises either to gain a niche in the market or to increase sales usually in difficult times such as business recession. Sufficiency of the extent of trade debts is usually judged by receivables turnover ratio also called collection ratio or book debts to sales ratio. Too high a ratio would indicate early collection of book debts and too low would indication

extension of long credit periods. The question of how long is long is usually resolved by making an inter-firm and intra-firm comparison. An absolute position is never a good indicator; a comparison gives a clearer picture.

If in the past 45 days credit was being extended and now this is reduced to 40 days it indicates a better position. But, if on a comparison with other business in same business and in the same area, one discovers the usual credit period extended in 30 days then 40 days credit is indicative of a bad position!

At times, the receivables, turnover ratio may become low because there is a big chunk of old trade debts that are being carried. To enable a proper analysis a statement of trade debts age-wise would then be in order. Business with bad paymasters may be slowed or completely stopped especially when they are not paying.

The measurement of receivables has always been a contentious issue in small enterprises. Small Scale Entrepreneurs usually do not like to write off bad debts (uncollectible accounts) and reduce these from the balance sheet as well as the income statement' lest this reduces profits. To impress bankers and other creditors they prefer to carry on trade debts even when they are over a year old. This is bad practice.

At times, entrepreneurs increase the trade debts unusually high especially around year end so as to show an increased sales in a bid to impress their bankers. Such a ' practice is not only undesirable but can be dangerous and costly.

Neither too high nor too low a receivables turnover ratio is good. A too high a ratio may indicate over-zealousness in collecting trade debts; possibly at the cost of hurting some good old-time customers resulting in loss of future business'.

Too low a ratio may mean an undesirably large trade debt portfolio resulting in locking up of costly funds besides increased collection cost and bad debts. The right credit period will be determined by a trade off between cost of funds, cost of cash discount or early payment, bad debts, collection cost and profitability. Such business must leave a net surplus. Stretching credit term to obtain sales is not indicative of a wholesome condition.

However, as a general rule when business is good, period of trade debt should be reduced and when business is bad, credit on sales may be extended. This sounds simple but would not be so easy in actual practice.

Cash

Cash is a necessary evil. It is necessary as it acts as a lubricant that facilitates day-to-day business operations. But then, why is it an evil?

Is cash a source of funds or a use of funds? Have a look at the balance sheet shown in Figure I

Fig. 1: Balance Sheet

	LIABILITIES		ASSETS
	Rs.		Rs.
Proprietor's	…………	Cash	……..
Capital	…………	…….	………
………..	…………		

Where is cash appearing? On the asset side. That means it is a use of funds. Whatever cash you are having whether in hand or at bank is coming from funds which are liabilities: Such funds have cost associated with them. Therefore, carrying too high a cash increases cost of funds and carrying too low would mean facing embarrassment in business owing to inability to make payment of expenses due. One must carry the right amount of cash which would be an amount just sufficient to enable you make payment of all expenses as and when they fall due.

Activity 5

1) A new enterprise should preferably own/rent out business premises.
2) In times of business boom trade debts should be ……………………
3) Cash on hand is
   a) source of funds
   b) use of funds

Ans: 1) rent out 2) decreased 3) use of funds

10.6 GROWTH STRATEGY -- THE FINANCIAL. IMPLICATION

Good financial management is one which ensures that a business enterprise is live and kicking. That is, it is growing. Business growth is dependent on solvency, credibility, ability to raise funds, availability of resources and liquidity.

Solvency

To keep the business running its solvency must be maintained at all times. Solvency is the ability of the business firm to pay off all debts. It is measured by Tangible Net Worth.

Tangible Net worth

= Own funds (or Net worth) - Intangible Assets

If tangible net worth is positive, the enterprise is solvent; if negative, it is insolvent Such industrial units have negative tangible net worth.

Bankers also keep a track on solvency position by monitoring the debt; equity ratio. In Indian situation a debt-equity ratio of 3:1 is allowed for SSE. Usually the tendency amongst small entrepreneurs is to borrow to the hilt, that is, keep debt-equity ratio to its maximum level of 3:1. In a new enterprise, during gestation period losses are certain. If these losses exceed your equity, the firm's tangible net worth becomes negative: it becomes insolvent or sick. Thus a stigma-gets attached to it and the firm spoils its chance of growth.

Debt-equity ratio should be kept as low as possible. If you start with 3:1 reduce it. How? (a) By reducing debt; and, (b) by increasing equity. Equity can be increased by investing additional funds from your own sources or by ploughing back profits. A reduced debt-equity ratio gives you leverage to borrow. It indicates your debt raising capacity. Thus, if debt is Rs. 2 lakhs and equity Rs. 1 lakh, debt-equity ratio is 2:1.Since 3:1, is permissible, when opportunity comes for growth, you would be in a position to borrow an additional Rs. 1 lakh.

Credibility

Credibility is the bedrock on which all businesses - small, medium or large - run. As the old adage goes, if reputation is lost everything is lost. Maintaining credibility in business not only ensures sustainability but also growth. Credibility ensures finance and availability of adequate finance leads to business viability. The reverse relationship is also true. If business proposal is viable, finance is available; and, if a businessman has finance his credibility gets more easily established. This relationship can be expressed in the following equation.

Viability = Finance = Credibility

How is credibility established? By sticking to your commitments. If you project certain sales, production and profit, work assiduously to achieve them, to make them come true. Similarly, if certain payments are committed to your bankers, creditors or others, ensure you pay them when due. If you keep paying your material suppliers on time, when need arises you telephone them to send double the normal quantity (say, Rs. 2 lakhs as against Rs. 1 lakh normally) the- supplier gladly obliges. Thus, on telephone you have raised Rs. 2 lakhs. If, however, supplier was paid hesitantly and with great difficulty, would he so oblige? Definitely not. This is true of all creditors, including bankers. Thus credibility ensures finance and hence business growth.

Trading on Equity

A business enterprise- using borrowed capital along with its own capital is said to be “trading on equity”. If equity is more than borrowed capital it is described as highly geared; and, if the own capital employed is less than borrowed capital, it is said to be low geared. In a highly geared capital the return on equity is generally low and in low geared capital it is high provided cost of capital is, lower than return on capital.

Suppose return on capital is 30%. Interest on borrowing is 15%. The return on equity is shown in Table 10.1 in situation 1 of high gear and situation 2 of low gear.

Table 10.1
Effect of trading on equity.

Situation	Gearing	Equity	Borrowing	Profit Before Interest	Profit After Interest	ROE
1.	Low	Rs. 1,00,000	Rs. 2,00,000	Rs. 90,000	60,000	60%
2.	High	2,00,000	1,00,000	90,000	75,000	37.5%

Thus, low gearing gives

ROE of 60% and high gearing 37.5%

This makes trading on equity attractive. An owner of SSE would like to borrow more and more to maximise ROE. When there is business boom, there are orders on hand, economy is looking up, there is enthusiasm everywhere and even creditors like to lend more and more leading to a situation of overtrading. However, in business such situation does not last forever. Soon recession may set in or a large order may get cancelled or any unfavourable event may take place. With drop in sales, profits would decline, interest payment may suffer and creditors will stop further credit suppliers and-may even take away their materials. Thus, stocks decline, current assets are reduced, production suffers, profits are further affected, worker morale goes down payment position further worsens leading to a definite slide-down and general gloom all over. A healthy business is now sliding down to its doom.

The moral is : keep trading on equity within healthy limit. Even if attractive opportunities are before you, do not borrow more till you have widened your equity base **pari-passu** That is, hold on to your debt-equity ratio; do not allow it to worsen.

Liquidity

Liquidity is short-term solvency. While insolvency is faced only once in the life of a business illiquidity is faced from time to time. Liquidity of a firm is its ability to meet expenses incurred in the short run. This is most essential for maintaining the firm's credibility and potential for growth.

It is measured by Current Ratio, Acid Test Ratio and Net Working Capital. Current Ratio should be 2 or more (minimum acceptable to an Indian banker is 1.33). Along with the Net Working Capital should increase from year to year. From Figure 2 it may be observed that for Current Ratio to be more than one, current assets will be greater than current liabilities meaning thereby investment of funds from equity and other long-term sources in current assets. Current asset-size remaining same profit level would remain constant lowering return on equity. This is not tenable to the owner of a business. He would, therefore, be interested in lower Current Ratio at the expense of impairing liquidity.

Fig. 2: Concept of NWC

LIABILITIES	ASSETS
Long-terra Funds (Equity + Funded Debts)	Fixed Assets
Current Liabilities	Current Assets

To tide over liquidity crunch, the entrepreneur should prepare projected cash flow statements on a monthly basis and initiate corrective action well in time.

Activity 6

1) If own funds are Rs. 1,70,000 and intangible assets Rs. 90,000, tangible net worth is Rs ……………………

2) If current assets are Rs. 2,50, 000 and current liabilities Rs. 1,30,000, networking capital is Rs ………………………..

3) Increase in net working capital from Rs. 50,000 last year to Rs. 75,000 this year indicates the liquidity of the firm has ………………….

Ans. 1) 80,000 2) 1,20,000 3) improved.

10.7 MANAGING LIABILITIES

If finances of the business enterprise are to be managed comprehensively, both assets and liabilities require to be managed. Managing liabilities is as important as asset management. Many a firm is known not to have progressed well because it could not manage its trade credits or accrued expenses.

Accrued Expenses

In business many expenses like rent, salaries and wages, taxes etc. get accrued but are not payable. Till such time as the expenses are incurred but not payable (the enterprise has taken the benefit of such goods or services on which account expenses are incurred) they are termed as accrued expenses. These are an important source of funds. When an enterprise requires funds, the entrepreneur should not pay off the expenses till they become payable. There is no sense in being over-zealous and making early payments especially when the enterprise requires funds. There are mutually and legally acceptable due dates. Hold payments till such dates and utilise such funds for day-to-day operations. But do take care that on due dates sufficient funds are available to make payments and maintain business credibility.

Trade Credits

Like accrued expenses trade credits should not be paid off till they are due, especially 'when your firm is in need of money. By making timely payments credibility is assured.

If credit is extended on sales, it makes sense to avail credit on purchases. By and large these should be equal though this is not a hard and fast rule. If trade debts are more than trade credits, it means market of your product is not so good. If trade credits are more than trade debts it could mean you are overstretching credit purchases or chasing your customers for early payments or demand of your product is so high that customers pay on cash or near cash basis.

However, remember nothing in this world is free. Your supplier may not charge interest on credit supplies but it is in built. He may overcharge; or, sell inferior quality goods; or, give least preference in supplies and so on. At times, suppliers offer cash discount on early payments. Suppose you buy Rs. 1 lakh worth of goods on 30 days credit and the supplier offers 2% cash discount for payment within 10 days. Then for availing Rs. 1 lakh credit for 20 days you lose 2% discount. This works out to 36% $\left(2\% \times \frac{360 \text{ days}}{2 \text{ days}}\right)$ on an yearly basis. In fact, you gain 18%q per annum if the cash discount is availed of evert by taking bank' credit at 18% interest!

The use of credit from suppliers is an important source of meeting short-term requirements of funds. But this should not be at the cost of losing suppliers' goodwill or compromising on other trade terms.

Activity 7

Fill in the blanks.

1) Accrued expenses are a ……………………………………………of funds.
2) To maintain credibility of the business firm trade credits should be paid off in ……………………………………………………………………………….
3) Suppliers offer discount for early payments.

Ans. 1) source 2) time 3) cash

10.8 MAINTAINING ACCOUNTS

Accounts are the raw material of financial planning. Financial accounting provides financial information to parties within and outside the business-. the entrepreneur, banker, creditors, statutory Government agencies and others. Survival and success of a small business depends on a healthy relationship between its three key players - the banker, the small business person and the accountant. Most small business firms do not maintain accounts even when they have availed bank credit which always stipulates provision of adequate book-keeping. To the small-scale entrepreneur an accountant is a costly provision. The business operations, according to him, are not many and he feels he knows and understands all the transactions.

In the absence of proper accounts, losses are incurred, pilferages take place; dues remain uncollected and most operations are conducted in the most unbusiness like manner. Bankers and statutory requirements like stock statements, returns, financial• statements are either not prepared or prepared late and in an adhoc manner creating ' mutual suspicion and affecting relationship.

If an entrepreneur cannot afford a full-time accountant, he should employ a part-time accountant or maintain accounts himself. The cost of hiring an accountant gets paid many times over. All successful businessmen have an accountant handy and maintain up-to-date accounts. They realise in the absence of adequate book-keeping and account they do not have a correct picture of costs, expenses, sales, trade debts, trade credits, tax liabilities, profits and return. It helps in establishing credibility with bankers, tax authorities and others. Every businessman must regularly maintain proper accounts to ensure financial planning, midway corrective action and profits.

10.9 SUMMARY

Critical issues in financial management require to be constantly borne in mind to ensure that a small-scale business enterprise remains healthy. Planning for profits must be ensured at all times by resorting to periodical performance evaluation. While reporting such performance, actual or planned the merits of being conservative should not be lost sight of.

Proper utilisation of various assets is critical to profit maximisation. Along with credibility, solvency and liquidity are essential for enterprise growth. During emergencies liability management can be helpful. But all this would be possible only if proper books of accounts are maintained. An accountant ensures criticalities involved in financial planning and management are taken care of through timely provision of financial information. All aspects of financial management contribute in small or big measure to maintaining business survivability and growth.

10.10 FURTHER READINGS

Myer, John N., 1974, Financial Statement Analysis, Prentice-Hall of India Limited New Delhi.

Walker, Ernest W., 1974, Essentials of Financial Management, Prentice-Hall of India Private Limited: New Delhi.

Lambden, John C. & Targett, David, 1990, Small Business Finance - *A Simple Approach*. Pitman Publishing: London.