Unit - V

Q. What is financial planning? Explain in detail.

Financial Planning

Definition of Financial Planning

Financial Planning is the process of estimating the capital required and determining it's competition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise.

Objectives of Financial Planning

Financial Planning has got many objectives to look forward to:

a. **Determining capital requirements-** This will depend upon factors like cost of current and fixed assets, promotional expenses and long- range planning. Capital requirements have to be looked with both aspects: short- term and long- term requirements.
b. **Determining capital structure-** The capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business. This includes decisions of debt- equity ratio- both short-term and long- term.
c. **Framing financial policies** with regards to cash control, lending, borrowings, etc.
d. A finance manager **ensures that the scarce financial resources are maximally utilized in the best possible manner** at least cost in order to get maximum returns on investment.

<u>Importance of Financial Planning</u>

Financial Planning is process of framing objectives, policies, procedures, programmes and budgets regarding the financial activities of a concern. This ensures effective and adequate financial and investment policies. The importance can be outlined as-

1. Adequate funds have to be ensured.
2. Financial Planning helps in ensuring a reasonable balance between outflow and inflow of funds so that stability is maintained.
3. Financial Planning ensures that the suppliers of funds are easily investing in companies which exercise financial planning.
4. Financial Planning helps in making growth and expansion programmes which helps in long-run survival of the company.
5. Financial Planning reduces uncertainties with regards to changing market trends which can be faced easily through enough funds.
6. Financial Planning helps in reducing the uncertainties which can be a hindrance to growth of the company. This helps in ensuring stability an d profitability in concern.

<u>Need of Finance</u>

Q.What is the need of finance? Or Q.Why business need finance?

Finance is the money available to spend on business needs.

Right from the moment someone thinks of a business idea, there needs to be cash. As the business grows there are inevitably greater calls for more money to finance expansion. The day to day running of the business also needs money.

The main reasons a business needs finance are to:

Start a business

Depending on the type of business, it will need to finance the purchase of assets, materials and employing people. There will also need to be money to cover the running costs. It may be some time before the business generates enough cash from sales to pay for these costs. Link to cash flow forecasting.

Finance expansions to production capacity

As a business grows, it needs higher capacity and new technology to cut unit costs and keep up with competitors. New technology can be relatively expensive to the business and is seen as a **long term**investment, because the costs will outweigh the money saved or generated for a considerable period of time. And remember new technology is not just dealing with computer systems, but also new machinery and tools to perform processes quicker, more efficiently and with greater quality.

To develop and market new products

In fast moving markets, where competitors are constantly updating their products, a business needs to spend money on developing and marketing new products e.g. to do marketing research and test new products in "pilot" markets. These costs are not normally covered by sales of the products for some time (if at all), so money needs to be raised to pay for the research.

To enter new markets

When a business seeks to expand it may look to sell their products into new markets. These can be new geographical areas to sell to (e.g. export markets) or new types of customers. This costs money in terms of research and marketing e.g. advertising campaigns and setting up retail outlets.

Take-over or acquisition

When a business buys another business, it will need to find money to pay for the acquisition (acquisitions involve significant investment). This money will be used to pay owners of the business which is being bought.

Moving to new premises

Finance is needed to pay for simple expenses such as the cost of renting of removal vans, through to relocation packages for employees and the installation of machinery.

To pay for the day to day running of business

A business has many calls on its cash on a day to day basis, from paying a supplier for raw materials, paying the wages through to buying a new printer cartridge.

Choosing the Right Source of Finance

A business needs to assess the different types of finance based on the following criteria:

Amount of money required – a large amount of money is not available through some sources and the other sources of finance may not offer enough flexibility for a smaller amount.

How quickly the money is needed – the longer a business can spend trying to raise the money, normally the cheaper it is. However it may need the money very quickly (say if had to pay a big wage bill which if not paid would mean the factory would close down). The business would then have to accept a higher cost.

The cheapest option available – the cost of finance is normally measured in terms of the extra money that needs to be paid to secure the initial amount – the typical cost is the interest that has to be paid on the borrowed amount. The cheapest form of money to a business comes from its trading profits.

The amount of risk involved in the reason for the cash – a project which has less chance of leading to a profit is deemed more risky than one that does. Potential sources of finance (especially external sources) take this into account and may not lend money to higher risk business projects, unless there is some sort of guarantee that their money will be returned.

The length of time of the requirement for finance - a good entrepreneur will judge whether the finance needed is for a long-term project or short term and therefore decide what type of finance they wish to use.

Q.What are the sources of finance? Explain in detail.

Sources of Finance

Often the hardest part of starting a business is raising the money to get going. The entrepreneur might have a great idea and clear idea of how to turn it into a successful business. However, if sufficient finance can't be raised, it is unlikely that the business will get off the ground.

Raising finance for start-up requires careful planning. The entrepreneur needs to decide:

- How much finance is required?
- When and how long the finance is needed for?
- What security (if any) can be provided?
- Whether the entrepreneur is prepared to give up some control (ownership) of the start-up in return for investment?

The finance needs of a start-up should take account of these key areas:

- Set-up costs (the costs that are incurred before the business starts to trade)
- Starting investment in capacity (the fixed assets that the business needs before it can begin to trade)
- Working capital (the stocks needed by the business –e.g. r raw materials + allowance for amounts that will be owed by customers once sales begin)
- Growth and development (e.g. extra investment in capacity)

One way of categorising the sources of finance for a start-up is to divide them into sources which are from within the business (internal) and from outside providers (external).

Internal sources of Finance

The main internal sources of finance for a start-up are as follows:

Personal sources These are the most important sources of finance for a start-up, and we deal with them in more detail in a later section.

Retained profits This is the cash that is generated by the business when it trades profitably – another important source of finance for any business, large or small.**Note that retained profits can generate cash the moment trading has begun.** For example, a start-up sells the first batch of stock for £5,000 cash which it had bought for £2,000. That means that retained profits are £3,000 which can be used to finance further expansion or to pay for other trading costs and expenses.

Share capital – invested by the founder The founding entrepreneur (/s) may decide to invest in the share capital of a company, founded for the purpose of forming the start-up. This is a common method of financing a start-up. The founder provides all the share capital of the company, retaining 100% control over the business.

The advantages of investing in share capital are covered in the section on business structure. The key point to note here is that the entrepreneur may be using a variety of personal sources to invest in the shares. Once the investment has been made, it is the company that owns the money provided. The shareholder obtains a return on this investment through **dividends** (payments out of profits) and/or the value of the business when it is eventually sold.

A start-up company can also raise finance by selling shares to **external investors** – this is covered further below.

External sourcesof Finance

Loan capital This can take several forms, but the most common are a **bank loan** or**bank overdraft**.

A bank loan provides a **longer-term** kind of finance for a start-up, with the bank stating the fixed period over which the loan is provided (e.g. 5 years), the rate of interest and the timing and amount of repayments. The bank will usually require that the start-up provide some security for the loan, although this security normally comes in the form of personal guarantees provided by the entrepreneur. Bank loans are good for financing investment in fixed assets and are generally at a lower rate of interest that a bank overdraft. However, they don't provide much flexibility.

A bank overdraft is a more short-term kind of finance which is also widely used by start-ups and small businesses. An overdraft is really a loan facility – the bank lets the business "owe it money" when the bank balance goes below zero, in return for charging a high rate of interest. As a result, an overdraft is a flexible source of finance, in the sense that it is only used when needed. Bank overdrafts are excellent for helping a business handle seasonal fluctuations in cash flow or when the business runs into short-term cash flow problems (e.g. a major customer fails to pay on time). Two further loan-related sources of finance are worth knowing about:

Share capital – outside investors For a start-up, the main source of outside (external) investor in the share capital of a company is **friends and family** of the entrepreneur. Opinions differ on whether friends and family should be encouraged to invest in a start-up company. They may be prepared to invest substantial amounts for a longer period of time; they may not want to get too involved in the day-to-day operation of the business. Both of these are positives for the entrepreneur. However, there are pitfalls. Almost inevitably, tensions develop with family and friends as fellow shareholders.

Business angels are the other main kind of external investor in a start-up company. Business angels are professional investors who typically invest £10k - £750k. They prefer to invest in businesses with high growth prospects. Angels tend to have made their money by setting up and selling their own business – in other words they have proven entrepreneurial expertise. In addition to their money, Angels often make their own skills, experience and contacts available to the company. Getting the backing of an Angel can be a significant advantage to a start-up, although the entrepreneur needs to accept a loss of control over the business.

You will also see **Venture Capital** mentioned as a source of finance for start-ups. You need to be careful here. Venture capital is a specific kind of share investment that is made by **funds managed by professional investors.** Venture capitalists rarely invest in genuine start-ups or small businesses (their minimum investment is usually over £1m, often much more). They prefer to invest in businesses which have established themselves. Another term you may here is "private equity" – this is just another term for venture capital.

A start-up is much more likely to receive investment from a business angel than a venture capitalist.

Personal sources

As mentioned earlier, most start-ups make use of the personal financial arrangements of the founder. This can be personal savings or other cash balances that have been accumulated. It can be personal debt facilities which are made available to the business. It can also simply be the found working for nothing! The following notes explain these in a little more detail.

Savings and other "nest-eggs" An entrepreneur will often invest personal cash balances into a start-up. This is a cheap form of finance and it is readily available. Often the decision to start a business is prompted by a change in the personal circumstances of the entrepreneur – e.g. redundancy or an inheritance. Investing personal savings maximises the control the entrepreneur keeps over the business. It is also a strong signal of commitment to outside investors or providers of finance. Re-mortgaging is the most popular way of raising loan-related capital for a start-up. The way this works is simple. The entrepreneur takes out a second or larger mortgage on a private property and then invests some or all of this money into the business. The use of mortgaging like this provides access to relatively low-cost finance, although the risk is that, if the business fails, then the property will be lost too. .

Borrowing from friends and family This is also common. Friends and family who are supportive of the business idea provide money either directly to the entrepreneur or into the business. This can be quicker and cheaper to arrange (certainly compared with a standard bank loan) and the interest and repayment terms may be more flexible than a bank loan. However, borrowing in this way can add to the stress faced by an entrepreneur, particularly if the business gets into difficulties.

Credit cards This is a surprisingly popular way of financing a start-up. In fact, the use of credit cards is the most common source of finance amongst small businesses. It works like this. Each month, the entrepreneur pays for various business-related expenses on a credit card. 15 days later the credit card statement is sent in the post and the balance is paid by the business within the credit-free period. The effect is that the business gets access to a free credit period of aroudn30-45 days!

Comparison Chart

BASIS FOR COMPARISON	SHARES	DEBENTURES
Meaning	The shares are the owned funds of the company.	The debentures are the borrowed funds of the company.
What is it?	Shares represent the capital of the company.	Debentures represent the debt of the company.
Holder	The holder of shares is known as shareholder.	The holder of debentures is known as debenture holder.
Status of Holders	Owners	Creditors
Form of Return	Shareholders get the dividend.	Debenture holders get the interest.
Payment of return	Dividend can be paid to shareholders only out of profits.	Interest can be paid to debenture holders even if there is no profit.
Allowable deduction	Dividend is an appropriation of profit and so it is not allowed as deduction.	Interest is a business expense and so it is allowed as deduction from profit.
Security for payment	No	Yes
Voting Rights	The holders of shares have voting rights.	The holders of debentures do not have any voting rights.

BASIS FOR COMPARISON	SHARES	DEBENTURES
Conversion	Shares can never be converted into debentures.	Debentures can be converted into shares.
Repayment in the event of winding up	Shares are repaid after the payment of all the liabilities.	Debentures get priority over shares, and so they are repaid before shares.
Quantum	Dividend on shares is an appropriation of profit.	Interest on debentures is a charge against profit.
Trust Deed	No trust deed is executed in case of shares.	When the debentures are issued to the public, trust deed must be executed.

Definition of Shares

Smallest division of the company's capital is known as shares. The shares are offered for sale in the open market, i.e. stock market to raise capital for the company. The rate on which the shares are offered is known as share price. It represents the portion of ownership of the shareholder in the company. The shareholders are entitled to the dividend (if any) declared by the company on the shares.

The shares are movable i.e. transferable and consist of a distinctive number. The shares are broadly divided into two major categories:

- **Equity Shares:** The shares which carry voting rights on which the rate of dividend is not fixed. They are irredeemable in nature. In the event of winding up of the company equity, shares are repaid after the payment of all the liabilities.
- Preference Shares The shares which do not carry voting rights, but the rate of dividend is fixed. They are redeemable in nature. In the event of winding up of the company, preference shares are repaid before equity shares.

Definition of Debentures

A long-term debt instrument issued by the company under its common seal, to the debenture holder showing the indebtedness of the company. The capital raised by the company is the borrowed capital; that is why the debenture holders are the creditors of the company. The debentures can be redeemable or irredeemable in nature. They are freely transferable. The return on debentures is in the form of interest at a fixed rate.

Debentures are secured by a charge on assets, although unsecured debentures can also be issued. They do not carry voting rights. The debentures are of following types:

- Secured Debentures
- Unsecured Debentures
- Convertible Debentures
- Non-convertible Debentures
- Registered Debentures
- Bearer Debentures

Key Differences Between Shares and Debentures

The following are the major differences between Shares and Debentures:

1. The holder of shares is known as a shareholder while the holder of debentures is known as debenture holder.
2. Share is the capital of the company, but Debenture is the debt of the company.
3. The shares represent ownership of the shareholders in the company. On the other hand, debentures represent indebtedness of the company.
4. The income earned on shares is the dividend, but the income earned on debentures is interest.
5. The payment of dividend can be made only out of current profits of the business and not otherwise. Unlike the interest on debentures which has to be paid by the company to debenture holders, no matter company has earned profit or not.

6. Dividend is not a business expense and so is not allowed as deduction. On the contrary, interest on debentures is a expense and so allowed as a deduction.
7. In the event of winding up, debentures get priority of repayment over shares.
8. Shares cannot be converted as opposed to debentures are convertible.
9. There is no security charge created for payment of shares. Conversely, security charge is created for the payment of debentures.
10. A trust deed is not executed in case of shares whereas trust deed is executed when the debentures are issued to the public.
11. Unlike debenture holders, shareholders have voting rights.
12. Shares are issued at a discount subject to some legal compliance. Debentures can be issued at a discount without any legal compliance.