BACHELOR OF COMPUTER APPLICATIONS

SEMESTER 4

DCA2204

PRINCIPLES OF FINANCIAL ACCOUNTING AND MANAGEMENT

Unit 6

Financial Planning

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1. INTRODUCTION

The Finance Manager has to estimate the financial requirements of the company. He should determine the sources from which capital can be raised and determine how effectively and judiciously these funds are put into use so that repayments can be done in time. Financial planning is deciding in advance the course of action for future. It includes the following:

- Estimation of the amount of funds to be raised.
- Finding out the various sources of capital and the securities offered against the money so received.
- Laying down policies to administer the usage of funds in the most appropriate way.

1.1 Objectives

After studying this unit, you will be able to:

- *Explain the steps involved in Financial Planning.*
- *Explain the factors affecting Financial Plan.*
- *List the causes for over-capitalization.*
- *Explain the effects of under-capitalization.*

2. STEPS IN FINANCIAL PLANNING

- **Estimate capital requirements:** This is the first step in financial planning. The following factors may be used to determine the capital:
  - Requirement of fixed assets.
  - Investment required for intangible assets like patents, copyrights, etc.
  - Amount required for current assets like stocks, cash, bank balances, etc.
  - Cost of set-up and likely expenses to be incurred on the new issue of shares and debentures.
- **Determine the type of sources to be acquired and their proportion:** The Finance Manager has to decide on the form in which the money is to be sourced, that is, debt, equity, preference shares, loans from banks and the proportion in which these are to be procured.

Steps in Financial Planning:

The financial planning process involves the following steps:

1. **Projection of financial statements:** Financial statements are the company's profit and loss account and the balance sheet. These two statements can be prepared for a certain period of future time and they help the manager to determine the amount of fund required
2. **Determination of funds needed:** Once the projections are drawn in terms of sales of products, the cost of production, marketing activities, etc., the Finance Manager can draw up a plan as to the fund requirement based on the time factor. He can know whether the funds are to be procured on a short-term basis or on a long-term basis.
3. **Forecast the availability of funds:** A company will have a steady flow of funds. If the manager is able to forecast these amounts properly, then the moneys to be borrowed can be reduced, thus saving on the interest payments. So the manager should be a financial expertise also and have a thorough knowledge in all areas of running the organisation efficiently

4. **Establish and maintain control system:** Control system is ineffective without adequate planning and the adequacy of planning can be gauged only through proper control measures. Both these activities are essential for effective utilization of funds.
5. **Develop procedures:** Procedures should be developed for basic plans how they should be achieved with the right kind of planning and implementation and the final execution

Long term strategic plan

Long term plans generally range over a period of 2-5 years. These plans reflect the impact of long-term investment and financing decisions of the company. Generally, these plans focus on acquiring capital assets, R & D expenditure, new market penetration strategies, process engineering techniques, new and innovative product development strategies, etc. The long-term plans are supported by the annual plans.

Short term operating plans

These plans cover a period of 1-2 years. They deal with the implication of short-term decisions. These plans are generally called budgeting and include planning and controlling activities in the short run. The short-term plans consist of aspects such as sales, production, levels of inventories to be maintained, number of men (labour) to be used, cash flows etc.

3. FACTORS AFFECTING FINANCIAL PLAN

- **Nature of industry:** The nature of the industry in which the company is performing is a major factor which affects financial plans. A labour- intensive industry requires less capital than a capital-intensive industry.

- **Status of the company in the industry:** The status of the company is a factor which has to be considered while drawing a financial plan. If the company is a well-recognized and a reputed one, it will have no problems in raising finance at short notices. But on the other hand, if the company is a new entrant into the field, it will need time to establish itself and therefore raising money is slightly difficult, especially so if the company wants to go public. New firms may find it easier and better to take loans and function rather than going public.

- **Alternative sources of finance:** The Finance Manager will assess the alternative sources of funds and get the cheapest source of funds. He should also verify the conditions attached to the funds he procures, that are the contractual restrictions placed by the lenders.

- **Attitude of management towards control:** If the management wants to have control over the firm, it may not go in for the equity form of finance for control vests with equity shareholders and it gets diluted with every new issue of equity shares. Such companies prefer to raise additional amounts by debenture issue or bond issue.

- **Extent of working capital requirements:** The Finance Manager formulates his plan considering the short- and long-term financial needs of the firm. Short term funds required to finance working capital needs are to be procured through short term sources only. It is always a prudent policy to use short term avenues for short term requirements and long-term needs can be funded by the issue of shares and debentures.

- **Capital structure:** Capital of a firm has two components – debt and equity. The proportion of these should be so decided that the company gets the advantage of leverage. Running the company with loans and debentures will certainly help equity shareholders to get more income but the company is also functioning under a great risk.

- **Flexibility:** This is one important factor that should be kept in mind while planning. The financial plan should be flexible enough to adjust to the needs of the changing conditions. There should be flexibility to raise the amount from any source and similarly the repayments may be done any time the company has excess funds. The firm should also have the flexibility of substituting one form of financing with another if the need arises.

- **Government policy** with regard to financial controls, statutory provisions and controls should be considered. The SEBI guidelines should be strictly adhered to wherever applicable and necessary permissions from concerned authorities should be taken if necessary.

Self-Assessment Questions - 1

1. ____________ is the first step in financial planning.
2. __________ generally range over a period of 2-5 years and __________cover a period of 1-2 years.
3. A labour-intensive industry requires less capital than a __________ industry.
4. Capital of a firm has two components, namely, ________ and __________

4. ESTIMATION OF FINANCIAL REQUIREMENTS OF A FIRM

Estimating the capital requirements of a firm is a very complex and complicated process. The estimate should be correct, for wrong estimates will adversely affect the company. Capital requirements of a company broadly fall under two categories – fixed capital and working capital. Fixed capital refers to the capital to meet the long-term requirements of the business. Working capital is cash required for day-to-day activities.

4.1 Capitalization

Capitalization is the determination of the amount of capital to be raised, the types of securities that will be offered, the proportion in which they will be issued and the administration of capital. The components of capitalization are:

- Par value of share capital – paid up value of both equity and preference share capital.
- Reserves and surplus – all types of capital and revenue reserves.
- Long-term borrowed funds – debentures issued and other long-term borrowings.

Capitalization includes both own funds and borrowed funds. There are two approaches, that is, the theories for the determination of the amount of capitalization. They are:

Cost Approach: Under this approach, the capitalization of a company is based on the cost of acquisition of fixed assets, setting up a company and the amount of working capital requirement. The amount of capitalization is arrived at by adding the following items:

1. Cost of acquisition of fixed assets, such as, land and building, plant and machinery, furniture and fixtures, etc.
2. Cost of establishing the company – preliminary expenses incurred, underwriting commission, expenses on issue of shares, debentures, etc.
3. Working capital requirements.

The cost approach is not a preferred method of capitalization as the company's earning capacity should be taken into consideration rather than the total value of the assets the company holds.

Earnings Approach:

Under the Earnings Approach, the capitalization of the company is determined on the basis of its earnings. This approach advocates that the value of the company is equal to the value of its earnings. For example, if a company earns Rs. 100000 and the rate of capitalization is 12%, the company's capitalization would be calculated as: (Average profits*100) / rate of return, that is, (100000*100) / 12 which is equal to Rs. 833333.

The Earnings Approach provides a good basis for determining the capitalization of the existing company.

Over-capitalization

Over-capitalization arises when the present capital of the company is not effectively or properly used. There is excess capital available in the company than the actual requirement. A firm is said to be over-capitalized when its earnings are not sufficient to pay dividends to the investors. For example, if the company's rateof return is 12% and it earns a profit of Rs. 100000 on an investment of Rs. 1200000, we get the fair rate of return to be less than the profits earned. Fair rate of return is 1200000*12% which is Rs. 144000. The company is earning less than the fair return in the industry. The company is said to be over-capitalized because the earning of the company is (100000/1200000) *100 which is 8.33% and this is less than the fair rate return of the industry.

How do we know over-capitalization has occurred?

- Actual capitalization of the company exceeds the capitalization warranted by the activity levels.
- Earnings are lower than the expected returns.
- There is a fall in the rate of dividends declaration.
- There is a fall in the market value or the market price of the shares of the company.

Causes of over-capitalization:

- If a company acquires assets at inflated prices than the book values, over-capitalization occurs.
- Acquiring unproductive assets, mostly intangible in nature like goodwill, patents, etc.
- High initial costs by way of preliminary expenses.
- A company being set up in boom time pays more on acquisition of assets. Once the boom time subsides, it will find the capital over capitalized.
- Raising more capital than the required amount.
- Company borrows money at high rates of interest than the moneys could be put into profitable use.
- A company postponing plant repairs and maintenance will find itself over-capitalized as the efficiency of the plant stands reduced.
- Excessive taxation by government leaves very little money with the company. The money may be insufficient to meet its daily requirements and the company may resort to borrowings. Borrowing beyond a certain limit leads to over-capitalization

Effects of over-capitalization

- Fall in profits
- Fall in dividend rates
- Loss of investors' confidence
- Fall in market prices of shares.

Under-capitalization

Under-capitalization is the reverse to over-capitalization. It is a situation where the actual capitalization is much less than the proper capitalization. For example, if the company's average profits are Rs. 75000 and the actual capitalization is Rs. 500000 with an ROI of 12%,

(75000*100)/12 which is Rs. 625000. In case of under-capitalization the actual rate of earnings is higher than the fair rate of return, in our case 12%.

How do we know if under-capitalization has occurred?

- Actual capitalization is less than real ROI.
- Actual rate of earnings is higher than the ROI
- Dividends of the company are higher than companies in similar industry.
- Market price of share is very high.

Causes for under-capitalization

- Underestimation or wrong estimation of company's earning capacity.
- Acquiring assets during recession phase of the business cycle.
- Maintaining high standards of efficiency in company's workings.
- Conservative dividend policy.

Effects of under-capitalization

- Encourages competition and new competitors appear in the scene.
- Encourages management to manipulate share prices.
- High profits will attract high tax rates.
- High profits will make the workers demand higher wages.
- A feeling of exploitation sets in the minds of consumers that they are paying high prices to the company's products and the company may lose the goodwill of customers.

Self-Assessment Questions - 2

5. ____________is the determination of the amount of capital to be raised.
6. _____________arises when the present capital of the company is not effectively or properly used.
7. A company has ____________ if its actual capitalization is less than real ROI.
8. Conservative dividend policy results in ___________.

5. SUMMARY

- Financial planning is deciding in advance the course of action for future.
- The financial planning process involves the following five steps:
  - Projection of financial statements
  - Determination of funds needed
  - Forecast the availability of funds
  - Establish and maintain control system
  - Develop procedures
- Long term plans generally range over a period of 2-5 years. Short term plans cover a period of 1-2 years.
- Capitalization is the determination of the amount of capital to be raised, the types of securities that will be offered, the proportion in which they will be issued and the administration of capital.
- Under Cost Approach, the capitalization of a company is based on the cost of acquisition of fixed assets, setting up a company and the amount of working capital requirement.
- Under the Earnings Approach, the capitalization of the company is determined on the basis of its earnings.
- Over-capitalization arises when the present capital of the company is not effectively or properly used.
- Under-capitalization is a situation where the actual capitalization is much less than the proper capitalization.

6. TERMINAL QUESTIONS

Short answer type questions

1. Explain the "Alternate sources of funds" factor affecting Financial Plan.
2. What is over-capitalization?
3. Explain four effects of under-capitalization.

Long answer type questions

4. Explain the steps involved in Financial Planning
5. List the causes of over-capitalization
6. Write a short note on cost approach.

7. ANSWERS

Self-Assessment Questions

1. Estimation of capital requirements
2. Long term plans; short-term plans
3. Capital intensive industry
4. Debt; equity
5. Capitalization
6. Over-capitalization
7. Under-capitalization
8. Under-capitalization

Terminal Questions

1. The Finance Manager will assess the alternative sources of funds and get the cheapest source of funds. He should also verify the conditions attached to the funds he procures, that are the contractual restrictions placed by the lenders.

2. Over-capitalization arises when the present capital of the company is not effectively or properly used. There is excess capital available in the company than the actual requirement. A firm is said to be over-capitalized when its earnings are not sufficient to pay dividends to the investors.

3. Some effects of under capitalization are:
   - Encourages competition and new competitors appear in the scene.
   - Encourages management to manipulate share prices.
   - High profits will attract high tax rates.
   - High profits will make the workers demand higher wages

4. The financial planning process involves the following steps:
   - **Projection of financial statements:** Financial statements are the company's profit and loss account and the balance sheet. These two statements can be prepared for a certain period of future time and they help the manager to determine the amount of fund required
   - **Determination of funds needed:** Once the projections are drawn in terms of sales of products, the cost of production, marketing activities, etc., the Finance Manager can draw up a plan as to the fund requirement based on the time factor. He can know whether the funds are to be procured on a short-term basis or on a long-term basis.
   - **Forecast the availability of funds:** A company will have a steady flow of funds. If the manager is able to forecast these amounts properly, then the moneys to be borrowed can be reduced, thus saving on the interest payments. So the manager should be a financial expertise also and have a thorough knowledge in all areas of running the organisation efficiently
   - **Establish and maintain control system:** Control system is ineffective without adequate planning and the adequacy of planning can be gauged only through proper control measures. Both these activities are essential for effective utilization of funds.

5. The causes for over-capitalization are:
   - If a company acquires assets at inflated prices than the book values, over-capitalization occurs.
   - Acquiring unproductive assets, mostly intangible in nature like goodwill, patents, etc.
   - High initial costs by way of preliminary expenses.

- A company being set up in boom time pays more on acquisition of assets. Once the boom time subsides, it will find the capital over capitalized.
- Raising more capital than the required amount.
- Company borrows money at high rates of interest than the moneys could be put into profitable use.
- A company postponing plant repairs and maintenance will find itself over-capitalized as the efficiency of the plant stands reduced.

6. Under this approach, the capitalization of a company is based on the cost of acquisition of fixed assets, setting up a company and the amount of working capital requirement. The amount of capitalization is arrived at by adding the following items:

   Cost of acquisition of fixed assets, such as, land and building, plant and machinery, furniture and fixtures, etc.

   Cost of establishing the company – preliminary expenses incurred, underwriting commission, expenses on issue of shares, debentures, etc.

   Working capital requirements.

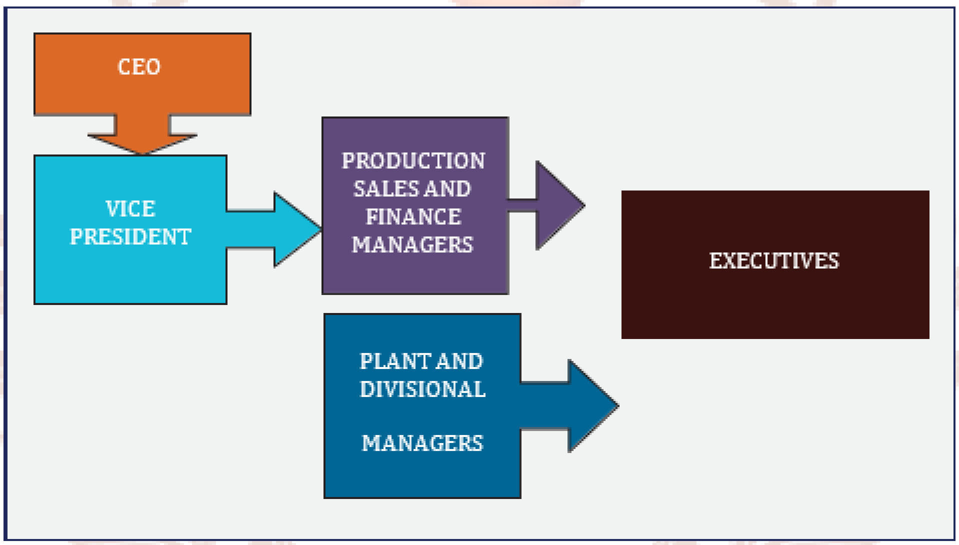
   The cost approach is not a preferred method of capitalization as the company's earning capacity should be taken into consideration rather than the total value of the assets the company holds.

8. CASE STUDY

Krishna Dairy

Krishna Dairy manufactures and sells milk and milk products. In this case we will study how responsibility accounting is applied to the cheese division of Krishna Dairy

Levels of Responsibility: Production manager has to control production costs; Sales manager has to control sales costs and finance manager has to control financing costs.



All the stake holders at all levels are going to be accountable for the costs at their level of operations and revenues, wherever it is applicable. At each level, they will be either a profit center or a cost center. At the vice president level, there will be an additional responsibility called investment center. At the vice president level, costs, revenue and investments in operating assets are covered. Responsibility is fixed and then accounting is carried out. Costs are identified, reported and controlled at each level for responsibility accounting. CEO has to ensure the overall costs for Krishna Dairy as a company are optimal and the company is in profit. Vice president has to ensure profitability of the cheese business.

9. REFERENCES

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- Miller, E. (1982). Costing Techniques and Responsibility Accounting.