INTRODUCTION TO INNOVATION, IP MANAGEMENT & ENTREPRENEURSHIP

FINANCIAL PLANNING

Financial Planning

Definition:
Financial planning is a systematic approach focused on financial matters within a business. It refers to the process of **estimating financial requirements** and **deciding the financing pattern** of a firm.

Key Elements of Financial Planning:

1. **Estimating Capital Requirements** – Assessing how much capital (both fixed and working) is needed.
2. **Deciding Financing Pattern** – Choosing the mix of equity and debt financing.
3. **Formulating Financial Policies** – Developing policies and procedures for:
    - Procurement of funds
    - Allocation of funds
    - Effective utilization of funds

Objectives of Financial Planning

1. **Determine Capital Requirements:**
   Identify both fixed and working capital needs for a given period.
2. **Choose Financing Sources:**
   Decide how much to raise from equity and how much from debt (debt-equity mix).
3. **Raise Funds Timely and Cost-Effectively:**
   Ensure funds are arranged on time at the lowest possible cost.
4. **Maintain Adequate Liquidity:**
   Avoid payment defaults and be prepared for unforeseen expenses (Keep enough cash or easily available funds to pay bills on time and handle unexpected expenses)
5. **Utilize Funds Efficiently:**
   Prevent both shortage and surplus of funds to maintain balance.

Essentials of a Sound Financial Plan

To make a financial plan effective and aligned with an organization's goals, the following key aspects must be ensured:

1. **Simplicity**
    - Keep the plan **easy** to understand and implement.

    - Prefer simple financial instruments like equity shares and fixed-interest debts over complex ones.

2. **Long-Term Perspective**
    - The plan should predict future money needs and make sure enough funds are available when needed.
    - It must be able to adapt to year-on-year changes in requirements.

3. Flexibility

- The plan should allow changes if unexpected things happen or business goals change.
- This helps the business stay strong and adjust in changing situations.

4. Optimal Use of Funds

- Raise only the amount of money needed — not too much or too little.
- Use every rupee wisely, with no money sitting unused.

5. Low Cost of Capital

- Keep the cost of getting funds as low as possible.
- Choose the best mix of equity and debt to give good returns to shareholders.

6. Adequate Liquidity

- Make sure cash is available when needed.
- Plan investments so they can be quickly turned into cash during emergencies or daily operations.

17.2 Types of Capital Requirement

Capital requirement of a business is broadly classified into:

1. **Fixed Capital Requirement**
2. **Working Capital Requirement**

17.2.1 Fixed Capital

Fixed capital is the capital needed to meet **long-term** or **permanent needs** of the business. It is used to acquire **fixed assets** such as:

- Land & Buildings

- Plant & Machinery
- Office Equipment
- Furniture & Fixtures

Purpose:

- Required while **starting a new enterprise**
- Also needed for **expansion** of existing operations

Source of Funds:

- Owner's capital (equity)
- Long-term sources like shares, debentures, and loans from financial institutions

Note: Investment in fixed capital is **long-term and non-liquid**, i.e., funds cannot be withdrawn easily.

17.2.2 Factors Determining Fixed Capital Requirement

Factor	Explanation
(a) Nature of Business	Industrial, shipping, or public utility businesses need heavy investment in machinery compared to trading businesses.
(b) Type of Product	Capital requirement varies with product complexity. E.g., toothpaste needs less fixed capital than steel or automobiles.
(c) Size of Business	Larger businesses need more capital for large-scale operations and infrastructure.
(d) Process of Production	Automated plants need more capital than manual or semi-automatic processes. Also, producing parts in-house vs. outsourcing affects capital needs.
(e) Method of Acquiring Assets	Buying assets with full payment needs more capital than buying on installment or lease basis.

17.2.3 Working Capital

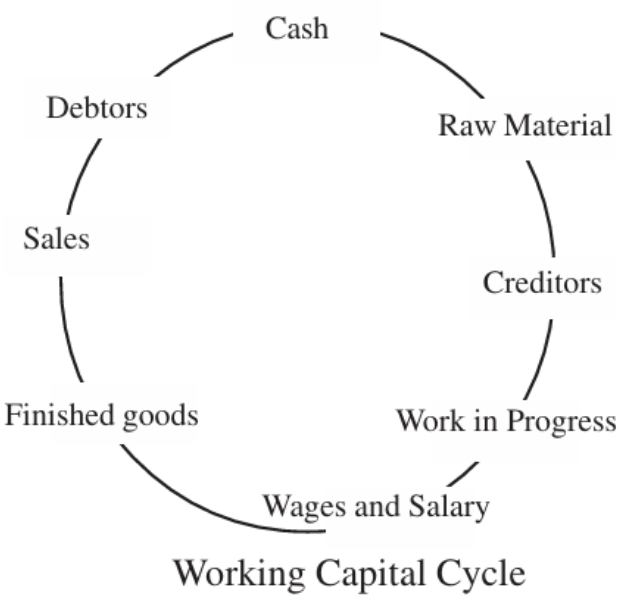
Definition:

Working capital refers to the funds invested in **current assets** like:

- **Cash**
- **Debtors**
- **Stock-in-trade** (raw materials, WIP, finished goods)

It is used for **day-to-day operations**, such as:

- Paying wages/salaries
- Settling dues to creditors
- Managing short-term obligations



Working Capital Cycle

Also Known As:

- **Circulating Capital**, because it keeps moving in a **working capital cycle**:

Types of Working Capital:

1. **Permanent (Fixed) Working Capital:**
    - Always required, regardless of scale of operations
    - Should be financed from long-term sources
2. **Fluctuating (Variable) Working Capital:**
    - Changes with business activity level or season
    - Financed through short-term sources like:
        - Bank overdraft
        - Trade credit
        - Bills payable

17.2.4 Factors Determining Working Capital Requirement

Factor	Description
(a) Nature of Business	Manufacturing firms need more working capital due to stock and credit sales; service firms and utilities need less due to cash transactions.
(b) Size of Business	Bigger firms = higher working capital needs due to larger inventory and receivables.

Factor	Description
(c) Length of Production Cycle	Longer cycle (e.g. cars, textiles) = more working capital; shorter cycle = less.
(d) Inventory Turnover Rate	High turnover (e.g. groceries) = less capital tied in stock; low turnover = more working capital.
(e) Credit Policy	Liberal credit to customers = more debtors = higher working capital needed.
(f) Seasonal Fluctuations	Seasonal businesses (e.g. woollens, fans) need more working capital during both peak and off-seasons due to stock accumulation.

17.3 Capitalisation

Meaning:
Capitalisation refers to the estimation of the total capital required by a business/company.

Theories of Capitalisation:

1. **Cost Theory** –

   According to the cost theory of capitalisation, the amount of capital required by the company is calculated by adding up the cost of its fixed assets, the amount of its working capital and the cost of establishing the business. This approach is simple and used widely in case of new companies.

   $$\text{Total capital} = \text{Fixed Assets} + \text{Working Capital} + \text{Setup Costs}$$

   (Used mostly for new businesses)

1. **Earning Theory** –

   $$\text{Total capital} = \frac{Average\ Annual\ Earnings}{Normal\ Rate\ of\ Return}$$

   (More rational as it relates capital to earning power)

17.3.1 Over-Capitalisation

A company is **over-capitalised** when it has **more capital than needed** or **more than justified by its earnings**.

- When actual capital employed > required capital (or)
- When actual return < normal return.

Example:

- If a company earns ₹2,00,000 yearly and the normal return rate is 10%, then:

    - Proper capital = ₹2,00,000 ÷ 10% = ₹20,00,000
- But if the company has actually employed ₹25,00,000, it is over-capitalised.
- Actual return = ₹2,00,000 ÷ ₹25,00,000 = 8%, which is less than 10%, confirming over-capitalisation.

Causes:

- Overpriced asset purchase
- Excessive capital raising
- Underutilised resources
- Wrong estimation of earnings or return rate
- High taxes

Effects:

- Lower dividends
- Falling share prices
- Difficulty in raising funds

Remedies:

- Reduce debt
- Use assets efficiently
- Avoid paying excess dividends (follow a conservative policy)

17.3.2 Under-Capitalisation

A company is **under-capitalised** when it has **less capital than needed** based on its high earnings.

Under-capitalisation means a company is **doing more with less** — earning high profits with comparatively **low capital investment**. It's like "chhoti si dukaan, bada dhanda"!

- When actual capital employed < required capital (or)
- When actual return > normal return.

Example:
Earnings: ₹2,00,000; Normal Return: 10% → Proper capital: ₹20,00,000
Actual capital: ₹16,00,000 → Under-capitalised

- If proper capital should be ₹20,00,000 (based on normal returns), but the company has only ₹16,00,000, it's **under-capitalised**.

- Also, if the company's **actual return** is **more than normal return**, it is **under-capitalised**.

Causes:

- Underestimated earnings
- Cost efficiency
- Low capitalisation rate
- Conservative dividend policies

Effects:

- Higher share prices
- Worker demand for higher wages
- Customer dissatisfaction
- Increased competition

Remedies:

- Issue bonus shares
- Split up shares (e.g., ₹10 → 5 × ₹2 shares)

Capital Structure (Simplified)

Capital Structure refers to how a company finances its operations using a mix of **ownership capital** and **borrowed capital**.

1. Ownership Capital

- This is the money **contributed by the owners** of the company (e.g., through shares).
- **Owners earn dividends**, but only after paying interest and taxes.
- If the company doesn't make profits, no dividends are paid.

2. Borrowed Capital

- This is money raised through **loans** or **debts**.
- The company must pay a fixed interest on this capital regularly, regardless of its profits.
- The principal (the original loan amount) must be paid back on maturity.

Why Use Borrowed Capital?

- Borrowed capital is beneficial if the return on the company’s business is greater than the interest it pays on loans.
- This allows the company to earn higher returns on the owners' funds.

Example of Capital Structure

Capital Structure

	Illustration - ‘A’ Total Capital Rs. 50 lakh (Rs. 20 lakh owners fund+ Rs. 30 lakh borrowed fund)	**Illustration - ‘B’ Total Capital Rs. 50 lakh (Rs. 50 lakh owners fund+ no borrowed fund**
Earnings before interest and tax (EBIT)	10,00,000	10,00,000
Less : Interest @ 10% on borrowed fund	3,00,000	—
Profit/Earnings after interest but before tax	7,00,000	10,00,000
Less : Tax on profit @ 40%	2,80,000	4,00,000
Profit after tax (PAT)	4,20,000	6,00,000
Return on owners’ funds $\left(\frac{\text{PAT}}{\text{Owners'funds}} \times 100\right)$	$\frac{4,20,000}{20,00,000} \times 100 = 21\%$	$\frac{6,00,000}{50,00,000} \times 100 = 12\%$

In the first scenario, the company used borrowed funds, and the return on the owners' funds was higher (21%) compared to when the entire capital was owned by the shareholders (12%).

This concept is known as **“Trading on Equity” or the **Leverage Effect**. However, using borrowed capital also involves **risk**. If the company’s profits decline, the interest on loans remains fixed, and the return on owners' funds may fall.

Capital Structure Decisions

There are two main decisions in planning capital structure:

1. **The type of securities to issue** (e.g., equity shares, debentures).
2. **The proportion of each security type** (the mix of debt and equity).

In short, a **balanced capital structure** involves choosing the right combination of **equity** (owners' funds) and **debt** (borrowed funds) to ensure profitability and manage risk.

Factors Determining the Capital Structure

When determining the capital structure, the finance manager of a company must carefully consider a variety of factors that influence the decision. An optimal capital structure balances the **mix of debt** and **equity**, impacting the **earnings per share (EPS)** and the **market value of shares**. Below are the key factors that affect the choice of capital structure:

1. Expected Earnings and Their Stability

- If the company expects high earnings, debt may be beneficial to leverage the earnings potential.
- However, if the earnings are volatile or uncertain, it's safer to rely more on equity capital to avoid financial strain from fixed interest payments.
- For **stable and growing earnings**, companies are likely to use more debt to capitalize on the **leverage effect**.

2. Cost of Debt

- Debt is preferable when the **cost of debt** (interest on loans) is lower than the **rate of return** on the capital employed. This helps reduce the overall financing cost and increases the return on equity capital.
- **Lower debt costs** make it advantageous for companies to take on more debt without significantly increasing their financial risks.

3. Right to Manage the Business

- **Debenture-holders** and **preference shareholders** do not have a say in the company's management. **Equity shareholders** (owners) have voting rights and control over the company.
- If the company's management wants to **retain control** over decision-making, they might prefer financing through **debentures** or **preference shares** instead of issuing too much equity.

4. Capital Market Conditions

- The state of the **capital market** affects the company's ability to raise funds through equity.
    - In **weak capital markets**, investors may be reluctant to subscribe to new shares, making **debt financing** a more viable option.
    - In a **strong capital market**, the company can issue shares more easily.

5. Regulatory Norms

- Legal constraints, such as limits on the **debt-equity ratio**, play a role in determining the capital structure.
    - In most cases, a **2:1 debt-equity ratio** is the limit, meaning the company cannot have more than twice the amount of debt compared to equity.
    - This ratio varies depending on the **industry** and **economic conditions**, so it's important to consider the regulatory norms in place.

6. Flexibility

- A company's capital structure should be **flexible** enough to raise additional funds when needed.
    - If the company relies heavily on **debt**, future borrowing may be limited.
    - **Equity-based capital** can be more difficult to adjust because shares cannot easily be redeemed.
    - **Redeemable securities** (e.g., preference shares, debentures) provide **more flexibility**, as they can be repaid when necessary.

7. Investors' Attitude Towards Investment

- Different types of investors have different preferences:
    - **Conservative investors** prefer low-risk investments, such as **debentures**, which offer fixed returns.
    - **Risk-seeking investors** prefer **equity shares** for the potential of high returns, despite the associated risk.
    - **Moderate investors** who are willing to take some risk for better returns may prefer **preference shares**.
- A well-balanced capital structure may involve issuing a mix of **equity**, **debentures**, and **preference shares** to cater to different investor preferences.

Optimal Capital Structure:

- The **optimal capital structure** minimizes the **cost of funds** (interest on debt, dividends on equity, etc.) and maximizes **shareholder wealth** by efficiently balancing debt and equity.
- This structure is the ideal one that brings the **highest value to shareholders** while managing risk and meeting all other strategic goals of the company.

Conclusion

An **appropriate capital structure** should aim to:

- **Maximize the return on equity** by using the leverage effect while maintaining reasonable risk levels.
- Consider the factors above to ensure the structure suits the company's financial goals, investor expectations, and market conditions.

17.5 DIVIDEND

Dividend is the portion of a **company's profit after tax** (PAT) that is distributed among its **shareholders**.

- It is not the entire profit; a part is retained for the company's future needs (called retained earnings), and the remaining is paid as dividend.
- The dividend paid to preference shareholders is known as **preference dividend**, and the dividend paid to equity shareholders is known as **equity dividend**.

In business, **profits or losses** are distributed differently depending on the type of business:

- **Proprietary Business**: Profit or loss is added or deducted from the proprietor's capital. Any withdrawal is called **drawings**.
- **Partnership**: Profit/loss is shared among partners as per the agreed ratio and included in their capital; drawings are also deducted.
- **Company**:
    - Profit distribution is more structured:
        1. Start with **PBIT (Profit Before Interest and Tax)**
        2. Subtract interest → Get **PBT (Profit Before Tax)**
        3. Subtract tax → Get **PAT (Profit After Tax)**
    - PAT is used for:
        - **Dividends** to shareholders
        - **Retained Earnings** for future company needs
    - Two types of dividends:
        - **Preference Dividend**: Paid at fixed rate before equity dividend
        - **Equity Dividend**: Paid to ordinary shareholders, amount varies

17.5.1 FACTORS AFFECTING DIVIDEND DECISIONS

When deciding how much **dividend** to pay, a company considers the following:

1. **Financial Needs of the Company**:
    - Retain profits for **expansion**, **debt repayment**, or **emergencies**.
    - Ensures **long-term stability**.
    - Hence, they may pay **lower dividends**.
2. **Liquidity Requirement**:
    - Profits ≠ Cash. Even if profits are high, low liquidity can prevent dividend payout.
    - Even with high profits, if cash is insufficient, a company may not be able to pay high dividends due to limited cash flow.
3. **Access to Capital Market**:
    - Companies with good credit and strong reputation can raise funds easily → may pay **higher dividends**.
    - Financially weak companies or bad market conditions → **conservative dividend policy**.
4. **Expectations of Shareholders**:
    - Some want capital growth; others (like retirees) want regular income.
    - Too low or skipped dividends can reduce market trust.
5. **Tax Policy**:
    - Changes in tax policy affect dividend decisions.
    - Now, companies pay tax on dividends (~12.5%) → slightly more liberal in paying dividends.
6. **Investment Opportunities and Growth**:
    - If good investment opportunities exist, company retains earnings.
    - If not, prefers to distribute profits to shareholders.
7. **Legal Constraints**:
    - Laws may restrict dividend payout:

- E.g., banking companies must keep statutory reserves.
- Capital profits can't usually be distributed.
- Loan agreements may impose dividend limits.

What You Have Learnt (17.6)

1. **Financial Management**
    - Overall managerial activity of handling finance.
2. **Financial Planning**
    - Estimating financial needs, deciding sources, and setting financial policies.
    - Effective financial planning must be simple, long-term, flexible, low-cost, and ensure liquidity.
3. **Types of Capital Requirement**
    - **Fixed Capital**: For long-term assets; depends on business nature, size, asset acquisition method.
    - **Working Capital**: For current assets; includes **permanent** (funded by long-term sources) and **fluctuating** needs (funded by short-term sources like bank overdrafts).
4. **Capitalisation**
    - Refers to determining the required capital based on **cost theory** or **earnings theory**.
    - **Over-capitalisation**: Capital > justified by earnings.
    - **Under-capitalisation**: Capital < justified by earnings.
5. **Capital Structure**
    - Mix of **equity (ownership capital)** and **debt (borrowed capital)**.
    - Factors influencing capital structure:
        1. Expected earnings
        2. Cost of debt
        3. Control rights
        4. Capital market condition
        5. Regulatory norms
        6. Flexibility

7. Investor attitude

6. **Dividend**
    - Portion of profits distributed to shareholders.
    - Factors affecting dividend decisions:
        - Future financial needs
        - Liquidity
        - Market access
        - Shareholders' expectations
        - Tax policy
        - Investment opportunities
        - Legal constraints

17.8 TERMINAL QUESTIONS

Very Short Answer Type Questions

1. What is meant by over-capitalisation?
Over-capitalisation refers to a situation where the actual capital employed by a firm is more than what is justified by its annual earnings.

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2. Define the term 'Dividend'.
Dividend refers to the amount of profits distributed by a company to its shareholders.

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3. What is meant by 'Optimal Capital Structure'?
Optimal Capital Structure is the judicious mix of debt and equity that ensures a higher return on owners' funds and minimizes the cost of capital.

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4. State any two effects of over-capitalisation.

- Reduced rate of return on capital employed.

- Decline in the market value of shares.

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5. Mention any two remedies of under-capitalisation.

- Issue of bonus shares to existing shareholders.
- Splitting of stock or increasing capital base through new share issues.

Short Answer Type Questions

6. State any four objectives of financial planning.
The four main objectives of financial planning are:

1. To ensure availability of adequate funds at the right time.
2. To ensure a proper balance between debt and equity capital.
3. To avoid unnecessary raising of funds.
4. To ensure flexibility so the company can adjust to changing financial needs.

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7. Explain any two factors that are taken into consideration while determining the fixed capital requirement of a company.

1. **Nature of Business:** Manufacturing businesses need more fixed capital than trading businesses due to investment in machinery and buildings.
2. **Method of Acquiring Fixed Assets:** If assets are acquired on installment or lease basis, the fixed capital requirement is lower compared to outright purchases.

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8. Do you advocate distribution of whole amount of profits earned by a company as dividends? Support your view with reasons.
No, I do not advocate full distribution of profits as dividends.
Reasons:

- A company needs to retain a portion of profits as **retained earnings** to finance future growth, meet contingencies, and ensure long-term solvency.
- Full distribution may affect liquidity and limit the company's ability to fund expansion or repay long-term debts.

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9. Describe any two determinants of capital structure.

1. **Expected Earnings and Their Stability:** Companies with stable and predictable earnings can afford higher debt in their capital structure.
2. **Cost of Debt:** If debt can be raised at a lower cost compared to equity and the return on investment is higher, more debt may be preferred.

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10. What is meant by 'Trading on Equity'?
Trading on Equity refers to the use of borrowed capital (debt) to increase the return on equity. It works when the return from investments made with borrowed funds is greater than the cost of those funds.

Long Answer Type Questions

11. What is meant by 'Financial Planning'? Explain any four requisites of a sound financial plan.

Financial Planning refers to the process of estimating the financial requirements of a business, determining the pattern of financing, and formulating policies and procedures for managing financial resources effectively. It ensures that the company can meet its objectives while minimizing the risk of financial failure.

Requisites of a Sound Financial Plan:

1. **Simplicity:** A financial plan must be simple to understand and implement, without unnecessary complexity. This makes it easier for management to track and execute.
2. **Long-Term View:** A financial plan should take into account the future growth and expansion of the business, ensuring that long-term financial needs are adequately met.
3. **Flexibility:** The plan must have the flexibility to adapt to unforeseen financial challenges and changes in business conditions, like market fluctuations or shifts in demand.
4. **Reasonable Cost:** The plan should aim to obtain financing at the lowest possible cost, ensuring that the company can maximize profitability and minimize debt burdens.

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12. How do you ascertain that a firm is over-capitalised? Explain with an example and state the main causes of over-capitalisation.

Over-capitalisation occurs when a firm has more capital invested in the business than it can justify by its earnings or potential to generate profits. In simpler terms, the firm is putting more capital into its operations than is necessary to generate its earnings.

How to ascertain over-capitalisation:

- If the firm's earnings are low relative to the capital employed, it is over-capitalised. This can be assessed by comparing the **actual return on capital employed** with the **expected return** based on the industry average.

Example:

- If a company has an investment of ₹10,000,000 but its annual profit is only ₹500,000, the return on capital employed (ROCE) is only 5%. However, if the industry average for a similar firm is 12%, this indicates over-capitalisation as the company is underperforming relative to the capital employed.

Main Causes of Over-Capitalisation:

1. **Over-valuation of assets**: Sometimes, companies inflate the value of their assets or overestimate their potential to generate returns.
2. **Excessive issue of shares**: Issuing too many shares may result in excessive capital in relation to the company's ability to use it profitably.
3. **Low profitability**: Firms with low profits relative to capital employed are more likely to be over-capitalised.
4. **Over-leveraging or excessive debt**: Borrowing too much in relation to equity can also lead to over-capitalisation.

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13. How does raising long-term funds through debt affect the return on shareholders' funds? Explain with an example.

Raising long-term funds through **debt** can increase the return on shareholders' funds, provided the return on investment from the borrowed funds exceeds the cost of debt. This practice is called **Trading on Equity**.

How it affects Return on Shareholders' Funds:

- When a company borrows funds at a lower interest rate and invests those funds in profitable ventures, the excess return generated from the investment (over the cost of debt) accrues to shareholders, thus increasing their return on equity (ROE).

Example:

- Suppose a company has ₹1,000,000 equity capital. If it generates ₹150,000 profit from its equity capital, the return on equity (ROE) is 15%.

- Now, if the company borrows ₹500,000 at an interest rate of 10%, it must pay ₹50,000 as interest. But if the borrowed funds generate a return of ₹100,000, the total profit becomes ₹200,000.
- The new return on equity is ₹200,000 / ₹1,500,000 (equity + debt) = 13.33%. Even though the company's total return increased, the cost of debt slightly reduces the overall return.

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14. What is meant by 'dividend'? State the factors that affect dividend decision.

Dividend refers to the portion of a company's profit that is distributed to its shareholders as a reward for their investment in the company. The dividend is usually paid in cash or in the form of additional shares (bonus shares).

Factors that affect dividend decisions:

1. **Financial Needs of the Company:** A company must retain some profits to meet future financial requirements, such as business expansion, paying off debt, or preparing for contingencies. Therefore, it may pay a lower dividend or defer it to retain more profits.
2. **Liquidity Requirements:** Even if a company earns a high profit, it may not have sufficient cash flow to pay a high dividend. The company must ensure that it has enough cash to meet its day-to-day operational needs.
3. **Tax Policy:** Taxation affects the amount of dividend a company pays. In some cases, a company may choose to pay less dividend and issue bonus shares to avoid higher taxes on dividends.
4. **Shareholder Expectations:** Some shareholders, particularly retired persons, rely on dividends as a source of income. Companies must consider such expectations when making dividend decisions.
5. **Legal Constraints:** Certain regulations or restrictions may prevent the distribution of dividends. For instance, companies may be required to maintain statutory reserves or may face legal limits on dividend payouts.

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15. How do you assess the amount of working capital required by a business unit? Describe in brief.

The amount of **working capital** required by a business is determined based on the nature and scale of operations. It is the amount needed to finance the day-to-day operations of a business.

Factors to assess working capital:

1. **Nature of the Business:** Manufacturing businesses typically need more working capital due to the need to purchase raw materials and pay for labor. Service industries may require less working capital.
2. **Length of the Production Cycle:** The longer it takes to produce and sell a product, the more working capital will be needed to cover the costs of production during the cycle.
3. **Inventory Turnover:** The faster the company sells its inventory, the lower the working capital required. Slow-moving inventory requires more working capital to fund unsold stock.
4. **Credit Policy:** A company's policy of offering credit to its customers will affect the working capital requirement. If customers are given more time to pay, the company will need more working capital to cover the outstanding receivables.
5. **Seasonal Factors:** Seasonal fluctuations can lead to higher working capital requirements during peak periods and lower requirements in off-seasons.

The formula for working capital is:
Working Capital = Current Assets – Current Liabilities