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Financial Planning



Financial planning means deciding in advance how much to spend, on what to spend according to the funds at your disposal

In the words of Gerestenbug financial planning includes:

- 1. Determination of amount of finance needed by an enterprise to carry out its operations smoothly** - The financial planning begins with determination of total capital requirement. In sales forecast if increase in sale is expected, then production capacity has to be increased i.e. more requirement of long term funds. Higher level of production and sales will require higher fixed as well as working capital.
- 2. Determination of sources of funds, i.e., the pattern of securities to be issued** - After estimating the requirements of funds the next step of financial planning is deciding how to raise this finance. Finance may be internally generated by the business or capital may have to be raised from external sources such as equity shares, preference shares, debentures, loans, etc.
- 3. Determination of suitable policies for proper utilization and administration of funds** - It includes long term investment decision. In financial planning finance manager analyses various investment plans and selects the most appropriate. Finance managers make short term financial plan called **budgets**.



Types Of Financial Planning

1. **Long term financial planning** – focuses on capital expenditure for long term growth and investment in business – usually 3 to 5 years.
2. **Short term financial planning** – in the form of budget – usually for a period of 1 year or less.



Objectives of Financial Planning

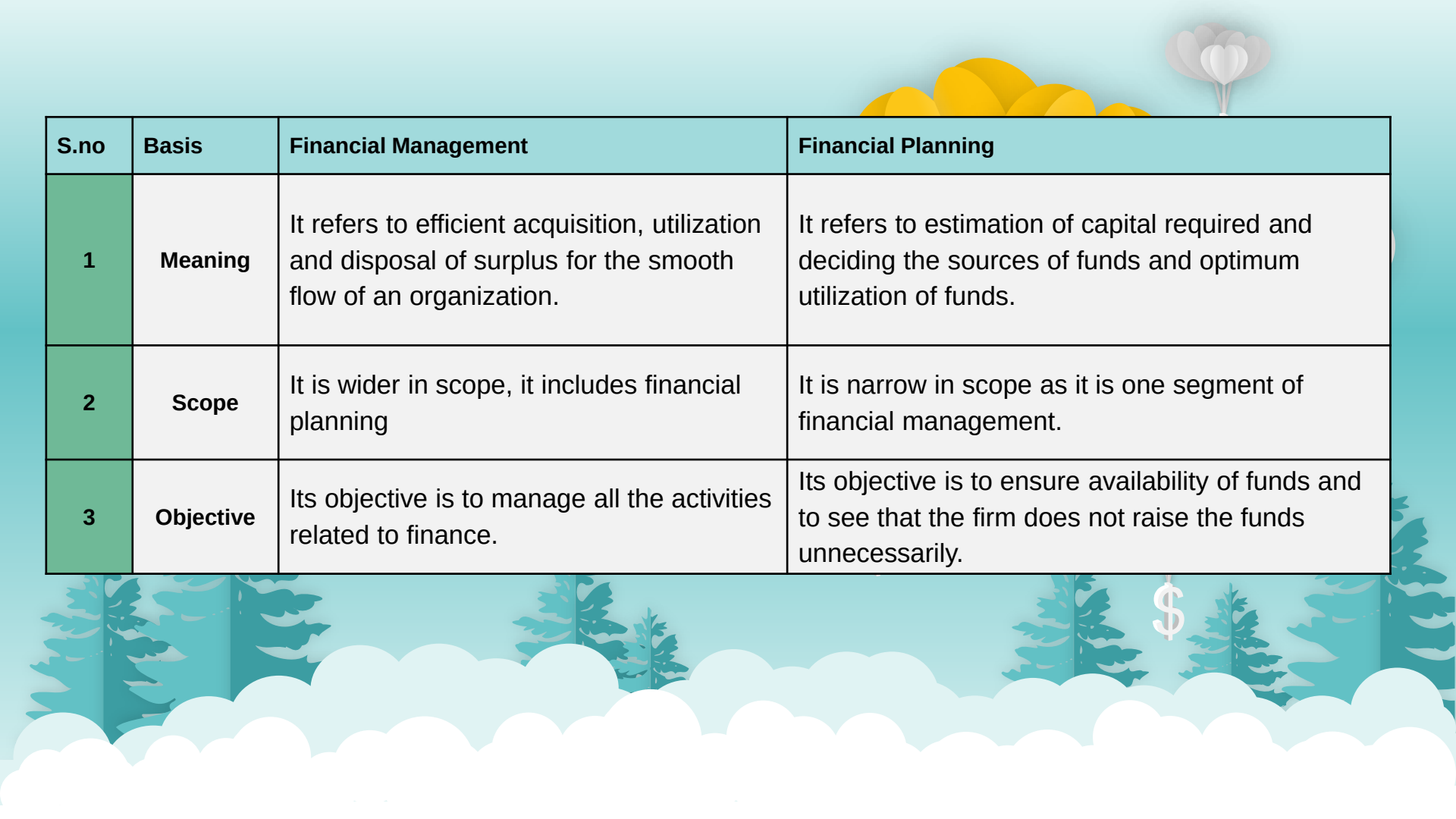
Financial planning is done to achieve the following two objectives:

1. **To ensure availability of funds whenever these are required** - the main objective of financial planning is that sufficient fund should be available in the company for different purposes such as for purchase of long term assets, to meet day-to-day expenses, etc. It ensures timely availability of finance. Along with availability financial planning also tries to specify the sources of finance.
2. **To see that firm does not raise resources unnecessarily** - Excess funding is as bad as inadequate or shortage of funds. If there is surplus money, financial planning must invest it in the best possible manner as keeping financial resources idle is a great loss for an organization.

Importance

1. **Makes the firm better prepared to face the future** - it helps in forecasting what may happen in future under different business situations so that management must know what to do in each situation.
2. **Help in avoiding business shocks and surprises** - by preparing blue print to face different types of situations.
3. **Coordinate various functions** - it helps in coordinating various functions the production' sales etc. By providing clear policies and procedures.
4. **Proper utilization of finance** - detailed plans of action prepared under financial planning reduce waste, duplication of efforts and gaps in planning.
5. **Link present with future** - it tries to link present with future by anticipating sale, growth' etc.
6. **Link between investment and financing decisions** - it provides link between investment and financing decisions on a continuous basis.
7. **Makes evaluation of actual performance earlier** - by spelling out detailed objectives for various business segments. It makes the evaluation of actual performance easier.





S.no	Basis	Financial Management	Financial Planning
1	Meaning	It refers to efficient acquisition, utilization and disposal of surplus for the smooth flow of an organization.	It refers to estimation of capital required and deciding the sources of funds and optimum utilization of funds.
2	Scope	It is wider in scope, it includes financial planning	It is narrow in scope as it is one segment of financial management.
3	Objective	Its objective is to manage all the activities related to finance.	Its objective is to ensure availability of funds and to see that the firm does not raise the funds unnecessarily.



Capital Structure

- ✚ Capital structure refers to the financing pattern or the proportion of the use of different sources in raising funds i.e. the mix between owners and borrowed funds.
- ✚ On the basis of ownership, the sources of business finance can be broadly classified into two categories viz.,
 - ✚ **Owners' funds** consist of equity share capital, preference share capital and reserves and surpluses or retained earnings.
 - ✚ **Borrowed funds** can be in the form of loans, debentures, public deposits etc. borrowed from banks, other financial institutions, debenture holders and public.



Debt and equity differ significantly in their cost and riskiness for the firm.

The cost of debt is lower than the cost of equity for a firm because the lender's risk is lower than the equity shareholder's risk, since the lender earns an assured return and repayment of capital and, therefore, they should require a lower rate of return.

Additionally, interest paid on debt is a deductible expense for computation of tax liability whereas dividends are paid out of after-tax profit.

Increased use of debt, therefore, is likely to lower the over-all cost of capital of the firm provided that the cost of equity remains unaffected.

Debt is cheaper but is more risky for a business because the payment of interest and the return of principal are obligatory for the business. Any default may force the business to go into liquidation. There is no such compulsion in case of equity, therefore, it's considered riskless for the business.

Higher use of debt increases the fixed financial charges of a business. As a result, increased use of debt increases the financial risk of a company.

Capital structure of a company, thus, affects both the profitability and the financial risk.

A capital structure will be said to be optimal when the proportion of debt and equity is such that it results in an increase in the value of the equity share.



Financial Leverage & Trading On Equity

- The proportion of debt in the overall capital is also called financial leverage. As the financial leverage increases, the cost of funds declines because of increased use of cheaper debt but the financial risk increases.
- The impact of financial leverage on the profitability of a business can be seen through EBIT-EPS (earnings before interest and taxes-earning per share) analysis as in the following example.
- Three situations are considered :-

1. There is no debt in situation
2. Debt of Rs. 10 lakh. All debt is at 10% p.a.
3. Debt of Rs. 20 lakh. All debt is at 10% p.a.

Total funds used = 30 lakh
Interest rate = 10% p.a.
Tax rate = 30%
e-bit = 4 lakh

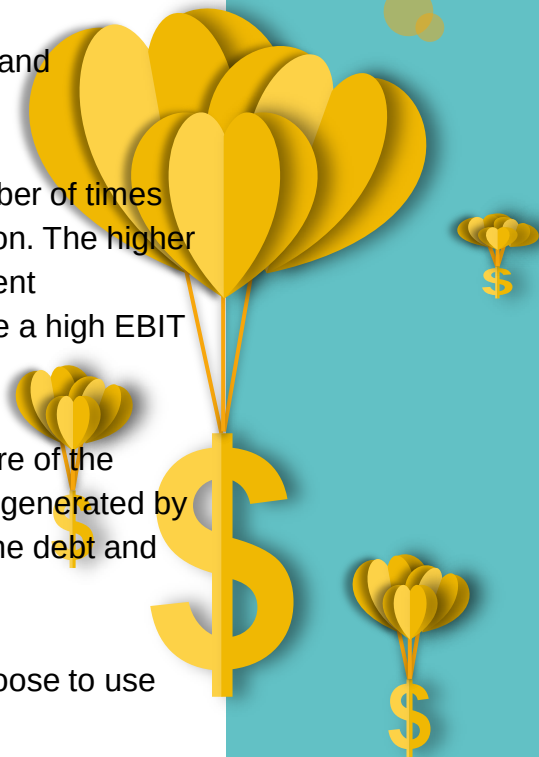
	Situation i	Situation ii	Situation iii
Debt	Nil	Rs. 10 lakh	Rs. 20 lakh
E bit	4,00,000	4,00,000	4,00,000
Interest	Nil	1,00,000	2,00,000
E-bit (earnings before taxes)	4,00,000	3,00,000	2,00,000
Tax	1,20,000	90,000	60,000
Eat (earnings after taxes)	2,80,000	2,10,000	1,40,000
No. Of shares of rs.10	3,00,000	2,00,000	1,00,000
Eps	0.93	1.05	1.40

- ✚ The company earns Rs. 0.93 per share if it is unlevered.
- ✚ With debt of Rs. 10 lakh its eps is Rs. 1.05.
- ✚ With a still higher debt of Rs. 20 lakh, its, eps rises to Rs. 1.40.
- ✚ Why is the EPS rising with higher debt? It is because the cost of debt is lower than the return that company is earning on funds employed.
- ✚ The company is earning a return on investment (ROI) of 13.33% e-bit this is higher than the 10% interest it is paying on debt funds.
- ✚ With higher use of debt, this difference between ROI and cost of debt increases the eps. This is a situation of favorable financial leverage.
- ✚ In cases, companies often employ more of cheaper debt to enhance the EPS. Such practice is called **Trading on Equity**.
- ✚ Trading on Equity refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest.
- ✚ An increase in debt may enhance the EPS but as pointed out earlier, it also raises the financial risk.
- ✚ Ideally, a company must choose that risk-return combination which maximizes shareholders' wealth. The debt-equity mix that achieves it, is the optimum capital structure.



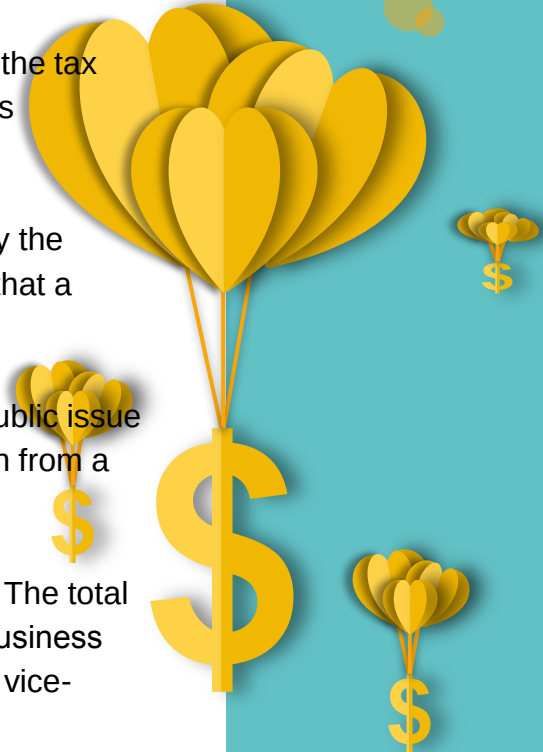
Factors Affecting Choice of Capital Structure

- 1. Cash flow position:** cash flows projected must not only cover fixed cash payment obligations but there must be sufficient buffer also for
 - Normal business operations;
 - For investment in fixed assets; and
 - For meeting the debt service commitments i.e., payment of interest and repayment of principal.
- 2. Interest coverage ratio (ICR):** the interest coverage ratio refers to the number of times earnings before interest and taxes of a company covers the interest obligation. The higher the ratio, lower shall be the risk of company failing to meet its interest payment obligations. However, this ratio is not an adequate measure. A firm may have a high EBIT but low cash balance.
- 3. Debt service coverage ratio (DSCR):** debt service coverage ratio takes care of the deficiencies referred to in the interest coverage ratio (ICR). The cash profits generated by the operations are compared with the total cash required for the service of the debt and the preference share capital.
- 4. Return on investment (ROI):** if the ROI of the company is higher, it can choose to use trading on equity to increase its eps, i.e., its ability to use debt is greater.



Factors Affecting Choice of Capital Structure

5. **Cost of debt:** a firm's ability to borrow at a lower rate increases its capacity to employ higher debt. Thus, more debt can be used if debt can be raised at a lower rate.
6. **Tax rate:** since interest is a deductible expense, cost of debt is affected by the tax rate. A higher tax rate, thus, makes debt relatively cheaper and increases its attraction vis-à-vis equity.
7. **Cost of equity:** when a company increases debt, the financial risk faced by the equity holders, increases. Along with the rate of return. It is for this reason that a company cannot use debt beyond a point.
8. **Floatation costs:** process of raising resources also involves some cost. Public issue of shares and debentures requires considerable expenditure. Getting a loan from a financial institution may not cost so Much.
9. **Risk consideration:** use of debt increases the financial risk of a business. The total risk depends upon both the business risk and the financial risk. If a firm's business risk i.e. fixed operating costs is lower, its capacity to use debt is higher and vice-versa.



Factors Affecting Choice of Capital Structure

10. **Flexibility:** if a firm uses its debt potential to the full, it loses flexibility to issue further debt. To maintain flexibility, it must maintain some borrowing power to take care of unforeseen circumstances.
11. **Control:** debt normally does not cause a dilution of control. A public issue of equity may reduce the managements' holding in the company and make it vulnerable to takeover. This factor also influences the choice between debt and equity .
12. **Regulatory framework:** every company operates within a regulatory framework provided by the law e.g., public issues of shares and debentures have to be made under SEBI guidelines. The ease with which these procedures can be completed also affects the choice of the source of finance.
13. **Stock market conditions:** if the stock markets are bullish, equity shares are more easily sold even at a higher price. However, during a bearish phase, a company may find raising of equity capital more difficult and it may opt for debt. Thus, stock market conditions often affect the choice between the two.
14. **Capital structure of other companies:** the management must know what the industry norms are, whether they are following them or deviating from them and adequate justification must be there in both cases. A useful guideline in the capital structure planning is the debt equity ratios of other companies in the same industry





Financial Risk refers to a position when a company is unable to meet its fixed financial charges namely interest payment, preference dividend and repayment obligations.

Apart from the financial risk, every business has some operating risk (also called business risk).

Business risk depends upon fixed operating costs. Higher fixed operating costs result in higher business risk and vice-versa.

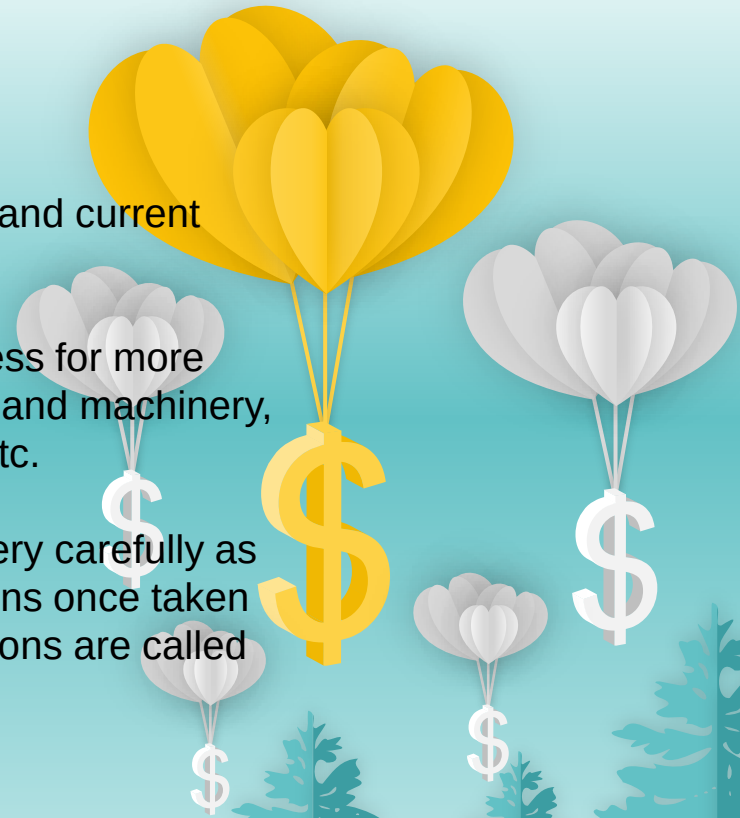




Fixed Capital

Meaning

- ✚ Investment is required to be made in fixed assets and current assets.
- ✚ Fixed assets are those which remain in the business for more than one year, usually for much longer, e.g., plant and machinery, furniture and fixture, land and building, vehicles, etc.
- ✚ Decision to invest in fixed assets must be taken very carefully as the investment is usually quite large. Such decisions once taken are irrevocable except at a huge loss. Such decisions are called capital budgeting decisions



Management Of Fixed Capital

- ✚ Fixed capital refers to investment in long-term assets.
- ✚ Management of fixed capital involves allocation of firm's capital to different projects or assets with long-term implications for the business.
- ✚ These decisions are called investment decisions or capital budgeting decisions and affect the growth, profitability and risk of the business in the long run.
- ✚ These long-term assets last for more than one year.
- ✚ It must be financed through long-term sources of capital such as equity or preference shares, debentures, long-term loans and retained earnings of the business.



The management of fixed capital or investment or capital budgeting decisions are important for the following reasons:

1. **Long-term growth:** these decisions have bearing on the long-term growth. The funds invested in long-term assets are likely to yield returns in the future. These will affect the future prospects of the business.
2. **Large amount of funds involved:** these decisions result in a substantial portion of capital funds being blocked in long-term projects. Therefore, these investments are planned after a detailed analysis is undertaken.
3. **Risk involved:** fixed capital involves investment of huge amounts. It affects the returns of the firm as a whole in the long-term. Therefore, investment decisions involving fixed capital influence the overall business risk complexion of the firm.
4. **Irreversible decisions:** these decisions once taken are not reversible without incurring heavy losses. Abandoning a project after heavy investment is made is quite costly in terms of waste of funds.



Factors Affecting The Requirement Of Fixed Capital

- 1. Nature of business:** the type of business has a bearing upon the fixed capital requirements. For example, a trading concern needs lower investment in fixed assets compared with a manufacturing organization; since it does not require to purchase plant and machinery, etc.
- 2. Scale of operations:** a larger organization operating at a higher scale needs bigger plant, more space etc. And therefore, requires higher investment in fixed assets when compared with the small organization.
- 3. Choice of technique:** some organizations are capital intensive whereas others are labour intensive. A capital-intensive organisation requires higher investment in plant and machinery labour intensive organizations require less investment in fixed assets. Hence, their fixed capital requirement is lower.
- 4. Technology upgradation:** computers become obsolete faster and are replaced much sooner than say, furniture. Thus, such organisations which use assets which are prone to obsolescence require higher fixed capital to purchase such assets.



5. **Growth prospects:** higher growth of an organisation generally requires higher investment in fixed assets. Even when such growth is expected, a company may choose to create higher capacity in order to meet the anticipated higher demand quicker.

6. **Diversification:** a firm may choose to diversify its operations for various reasons, with diversification, fixed capital requirements increase e.g., a textile company is diversifying and starting a cement manufacturing plant. Obviously, its investment in fixed capital will increase.

7. **Financing alternatives:** a developed financial market may provide leasing facilities as an alternative to outright purchase. Availability of leasing facilities reduces the funds requirement for fixed assets. Such a strategy is especially suitable in high risk lines of business.

8. **Level of collaboration:** certain business organisations share each other's facilities if the scale of operations of each one of them is not sufficient to make full use of the facility. Such collaboration reduces the level of investment in fixed assets for each one of the participating organisations.





Working Capital



❖ Apart from the investment in fixed assets every business organisation needs to invest in current assets. This investment facilitates smooth day-to-day operations of the business.

❖ Examples of current assets, in order of their liquidity, are as under.

1. Cash in hand/at Bank
2. Marketable securities
3. Bills receivable
4. Debtors
5. Finished goods inventory
6. Work in progress
7. Raw materials
8. Prepaid expense

❖ An asset is more liquid if it can be converted into cash quicker and without reduction in value. Current assets are usually more liquid but contribute less to the profits than fixed assets Hence, a balance needs to be struck between liquidity and profitability.



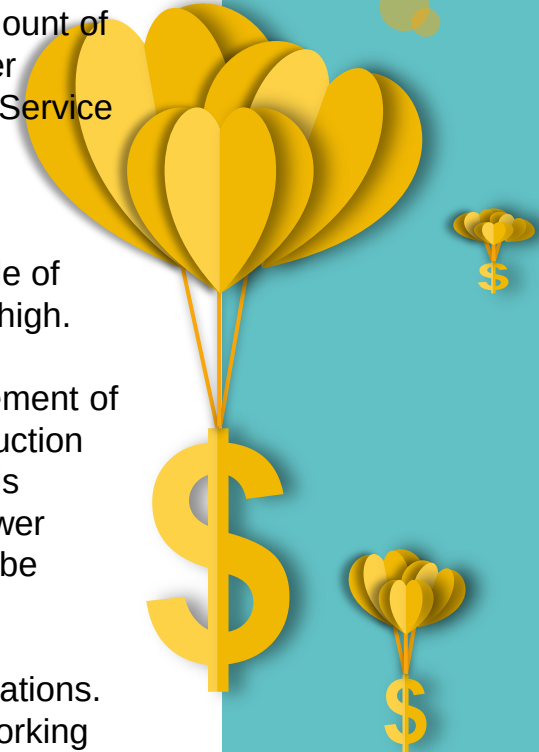
- ❖ Current liabilities are those payment obligations which are due for payment within one year; such as bills payable, creditors, outstanding expenses and advances received from customers, etc.
- ❖ Some part of current assets is usually financed through short-term sources, i.e., current liabilities. The rest is financed through long-term sources and is called net working capital. Thus, net working capital may be defined as the excess of current assets over current liabilities



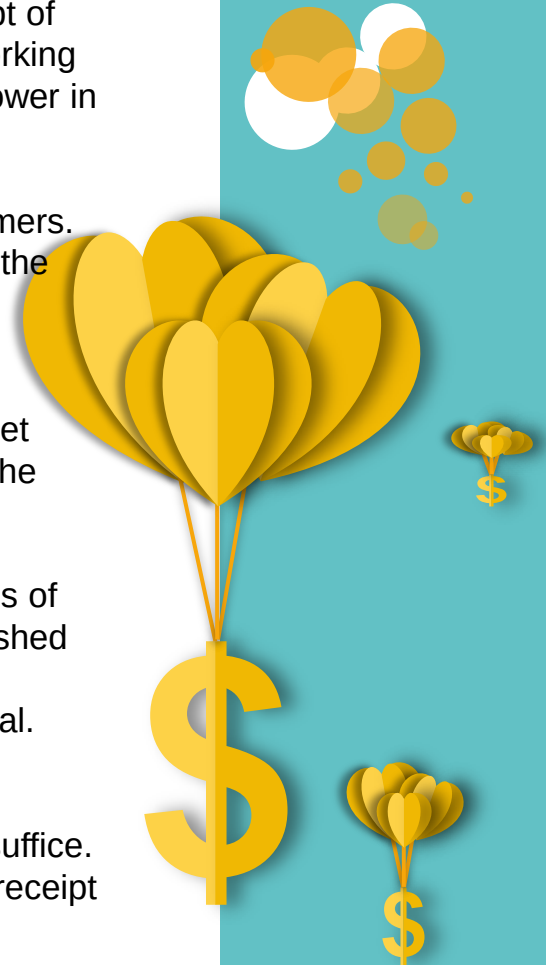
Factors Affecting Working Capital Requirements

A business concern must neither have excessive nor inadequate working capital. Both the situations are dangerous. Following are the factors influencing working capital requirements:

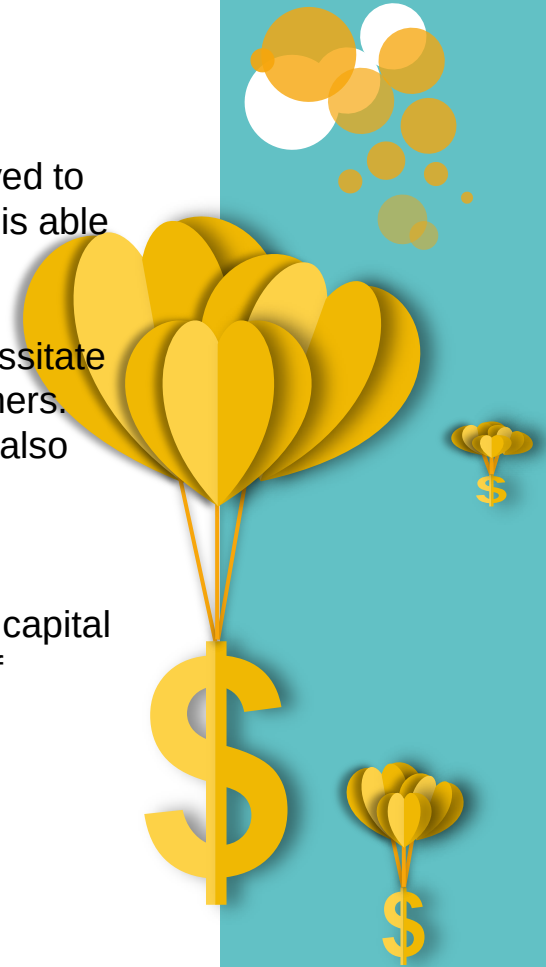
1. **Nature of business:** the basic nature of a business influences the amount of working capital required. A trading organisation usually needs a smaller amount of working capital compared to a manufacturing organisation. Service industries which usually do not have to maintain inventory require less working capital.
2. **Scale of operations:** for organisations which operate on a higher scale of operation, the quantum of inventory and debtors required is generally high.
3. **Business cycle:** different phases of business cycles affect the requirement of working capital by a firm. In case of a boom, the sales as well as production are likely to be larger and, therefore, larger amount of working capital is required. As against this, the requirement for working capital will be lower during the period of depression as the sales as well as production will be small.
4. **Seasonal factors:** most business have some seasonality in their operations. In peak season, because of higher level of activity, larger amount of working capital is required and lower during the lean season



5. **Production cycle:** production cycle is the time span between the receipt of raw material and their conversion into finished goods. Consequently, working capital requirement is higher in firms with longer processing cycle and lower in firms with shorter processing cycle.
6. **Credit allowed:** different firms allow different credit terms to their customers. These depend upon the level of competition that a firm faces as well as the credit worthiness of their clientele. A liberal credit policy results in higher amount of debtors, increasing the requirement of working capital.
7. **Credit availed:** just as a firm allows credit to its customers it also may get credit from its suppliers. To the extent it avails the credit on purchases, the working capital requirement is reduced.
8. **Operating efficiency:** firms manage their operations with varied degrees of efficiency. Better sales effort may reduce the average time for which finished goods inventory is held. Such efficiencies may reduce the level of raw materials, finished goods resulting in lower requirement of working capital.
9. **Availability of Raw Material:** If the raw materials and other required materials are available freely and continuously, lower stock levels may suffice. In addition, the time lag between the placement of order and the actual receipt of the materials (also called lead time) is also relevant.



10. **Growth Prospects:** If the growth potential of a concern is perceived to be higher, it will require larger amount of working capital so that it is able to meet higher production and sales target whenever required.
11. **Level of Competition:** Higher level of competitiveness may necessitate larger stocks of finished goods to meet urgent orders from customers. This increases the working capital requirement. Competition may also force the firm to extend liberal credit terms discussed earlier.
12. **Inflation:** With rising prices, larger amounts are required even to maintain a constant volume of production and sales. The working capital requirement of a business thus, become higher with higher rate of inflation.



A photograph of three cyclists riding on a narrow, grassy path that winds through a calm body of water. The cyclists are wearing colorful gear: one in red, one in black, and one in light blue. Their reflections are clearly visible in the still water. The background is filled with lush green trees and foliage, creating a serene and natural setting. The text "Thank you" is overlaid in a large, white, sans-serif font in the center of the image.

Thank you