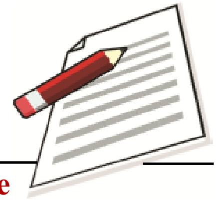


10

FINANCIAL PLANNING AND MANAGEMENT

Finance is the life blood of industry and commerce. Smooth and economic functioning of a business is not possible without the availability of adequate finance. No business activity can ever be pursued without financial support. Financial viability is perhaps the control theme of any business proposition. It is very difficult to conceive of a policy decision which will not have financial repercussions. Thus, effective management of finance is essential for the survival, growth and sound health of any business organisation.

Thus, in the absence of efficient financial management, several undesirable results are bound to follow. The absence of sound financial management during production and sales leads to an uneconomic use of funds and will ruin the fortunes of a company. So a well-informed and competent financial management is an absolute necessity for industrial development of the country.

LEARNING OUTCOMES

- explains different financial decisions taken by a finance manager;
- describes objectives of financial management ;
- identifies the basic long term and short term funds requirement ; and
- discusses the effects on business by leveraging on profits.

10.1 MEANING OF FINANCIAL MANAGEMENT

Financial management is concerned mainly with the procurement of funds in an economic and prudent manner and deploying these funds in most profitable way in a given risk situation, planning future operations and controlling current and future performance

and development through different tools.In other words, financial management is basically concerned with mainly three decisions, namely, investment decision, financing decision and dividend decision.

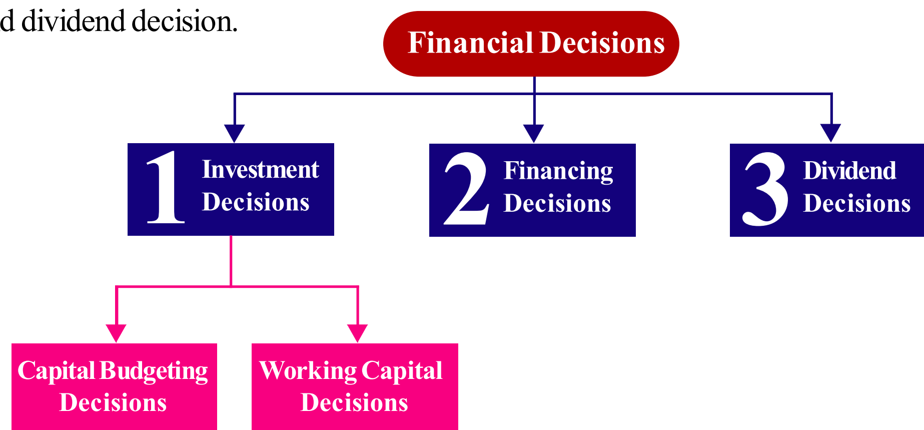


Fig.: 10.1 Financial Decisions

10.1.1 INVESTMENT DECISION

This decision involves careful selection of viable and productive assets in which funds have to be invested. It comprises:

(a) Decision relating to long term investment in fixed assets [called capital budgeting decision];

(b) Decision relating to short term investment in current assets [called working capital decision]

There are other two decisions also:*

(c) Decision relating to portfolio investment in securities; and

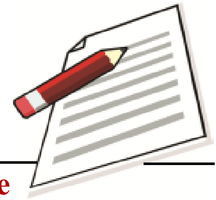
(d) Decision relating to merger and take-over investment

Investment decisions are influenced by cash flow by giving due care to time, value of money, risk involved, technological changes etc.To find out the viability of each capital expenditure decision,Capital budgeting, Cost-Volume-Profit analyses are the techniques generally used for the process of investment decisions.

10.1.2 FINANCING DECISION

Financing decision is concerned with the procurement of funds, in an economic and prudent manner after judicious identification of timing and quantum of various sources of funds to be raised. Funds are available through primary market, financial institution

*not to be considered in this unit



and through the commercial banks. The cost associated with each of the instrument or source of funds is different. The overall cost of capital must be kept at minimum. Proper Debt/Equity ratio should be maintained to maximize the returns to the shareholders. This decision will be made by considering the different factors Viz., inflation, size of the organisation, Government policies, etc. In this way, decision criteria in financing decisions are:

(a) What is the overall cost of capital which is to be raised? e.g.(i) cost of equity (ii) cost of retained earnings (iii) Cost of preference share (iv) cost of debenture (v) cost of other long term and short term debts (vi) Tax advantages (vii) cost of issue of instrument.

(b) What is the appropriate time of raising funds?

(c) Should the enterprise make underwriting arrangements? If yes, on what terms?

(d) What is the best mix (capital structure) of different instruments?

(e) Statutory provisions in connection with debt and equity.

(f) Threat of losing ownership of the company by take-over threat.

(g) Image of the company in the market.

(h) Liquidity of instruments

(i) How much fund is required?

(j) Chasing spontaneous, which is cost free, source of finance (trade creditors etc.) to finance inventories.

10.1.3 DIVIDEND DECISION

Dividend decision is concerned with taking decision with regards to the net profit distribution which is related either to pay dividend to shareholders or to retain in the business.Thus, Net profits are generally divided into two:

(a) Return to the Shareholders : Amount of Dividend and the rate of dividend to be decided.

(b) Retained profits : Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Hence, **the objective of a dividend decision should be to maximize a shareholders' return so that the value of his investment is maximized.** Equity Shareholders' return consists of two components viz, dividends and capital gains.

INTEXT QUESTIONS 10.1

1. A company plans to buy a latest machine which operates on new technology in order to replace an old and outdated machine. Identify the type of decision involved:

   a) Investment decision b) Financial decision c) Dividend decision

   d) All of the above.

2. A company decided to distribute a portion of the profits earned in the previous years among its share holders. Identity the type of decision involved.

   a) Financial decision b) Investment decision c) Dividend decision

   d) All of the above

3. A company assured the funds required to execute an expansion programme. Identify the decision made by the company.

   a) Financial decision b) Investment decision. c) Dividend decision,

   d) None of the above.

4. Financing decision relates to:

   a) Liabilities side of balance sheet (b) Assets side of balance sheet

   (c) profit & loss account (d) All of the above.

5. Investment decision relates to:

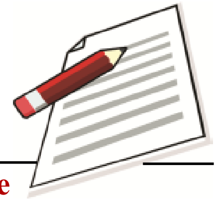
   a) Investment in fixed assets b) Investment in current assets

   c) Portfolio investment d) All of the above.

10.2 OBJECTIVES OF FINANCIAL MANAGEMENT

The key objectives of financial management are:

Profit Maximization: A business firm is an organization established for the primary purpose of making profit for its owner. Generally, profit maximization is regarded as the prime objective of the business. Profit as a means for enabling the company to grow without unduly hurting various interests will be acceptable. But profit alone as a goal may prove to be harmful to the company as a whole. It has been rejected as an operational criterion for maximizing the owners' economic welfare and as it fails to provide an operationally feasible measure for ranking alternative courses of action in



terms of their economic efficiency. It suffers from the following limitations:

(a) It is vague

(b) It ignores the timing of returns

(c) It ignores risk

Wealth Maximization and Value Maximization: It is commonly understood that the basic objective of a business is to maximize wealth which lies in maximization of the value of shares held by owners as they are the contributors to initial capital. For achieving this objective, the financial manager allocates the funds in assets and controls their use taking time, value of time into consideration. A business should aim at maximization of wealth and it depends on two factors namely, the profit earned per share and capitalization rate.

INTEXT QUESTION 10.2

1. Wealth maximization objective of financial management relates to:

   a) Increasing profit b) increasing revenue c) earnings per share

   d) all of the above.

2. Wealth maximization is superior to profit maximization because it considers:

   a) Time value of money b) competition c) cost d) capital structure.

10.3 FINANCIAL PLANNING

To understand what is financial planning, first you imagine that you have no money at present but willing to earn some income, what will you do? Certainly, you will go searching and evaluating the different available safe, secure alternative investment opportunities with growth prospective from where you can earn an income or return which is higher than cost.Then, at the time you will also try to find out from where you can raise or manage some money or funds,as you have no money, at lowest cost for investment purposes.This is called financial planning. Likewise, in business, financial planning involves investment and financing choice.

Thus, financial planning deals with framing of financial policies in relation to procurement of funds, investment of these funds and administration of funds of a business enterprise to achieve its objectives. Thus, financial planning involves the following facets:

(a) Estimating the current financial condition of the firm.

(b) Analyzing the future growth prospects and options.

(c) Appraising the investment options to achieve the predetermined growth objective.

(d) Projecting the future growth and profitability.

(e) Estimating funds requirement and considering alternative financing options.

(f) Comparing and choosing from alternative growth plans and financing options.

(g) Consequences of financial plans.

10.3.1 ESSENTIALS OF A SOUND FINANCIAL PLAN

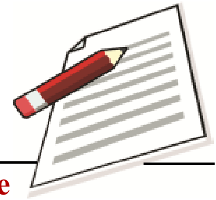
Financial planning is the process of identifying a firm's investment and financing needs, given its growth objectives. It is a trade-off between various investment options and financing option. Thus, while preparing a financial plan for any business unit, the following aspects should be kept in mind so as to ensure the success of such an exercise in meeting the organizational objectives.

(a) The plan must be simple: Now-a-days you have a large variety of securities that can be issued to raise capital from the financial market. But it is considered better to confine to owned funds (equity shares) and simple fixed interest-bearing finance (debentures and loans).

(b) It must take a long-term view: While estimating the capital needs of a business and raising the required funds, a long-term view is to be taken into consideration which means that besides the need of 'today', the capital requirements of 'tomorrow' should also be kept in view. It ensures that the plan fully provides for meeting the capital requirement on long term basis and takes care of the changes in capital requirement from year to year.

(c) It must be flexible: It is absolutely necessary that the financial plan must be capable of being adjusted and revised without any difficulty and delay so as to meet the future requirements of funds in changed business environment. Because no one may be able to properly visualise the possible developments in future. Not only that, the firm may also change its plans of expansion for various reasons.

(d) It must ensure optimal use of funds: Whatever funds a business is raising, it has some cost which a firm has to pay to the provider of capital. Hence, capital should not be only adequate but should also be employed in a productive way and there should be proper balance between fixed capital and working capital. There should not be idle funds otherwise the profitability will decline.



(e) **The cost of funds raised should be fully taken into account and kept at the lowest possible level:** It must be ensured that the cost of capital raised should be reasonable. The financial plan should provide for optimal capital structure (combination of debt and equity) which minimises the cost of capital and increases earnings per share, otherwise it will adversely affect the return on shareholders' funds.

(f) **Adequate liquidity must be ensured:** Liquidity refers closeness to cash which means the state of readiness to meet out the obligations of the firm as and when it becomes due during the course of the business. It has to be ensured in order to avoid any embarrassment to the management and the loss of goodwill among the investors. In other words, the investment of funds should be also kept in marketable securities so that it can be readily converted into cash to meet all possible eventualities.

10.3.2 IMPORTANCE OF FINANCIAL PLANNING

1. It helps to estimate accurate requirement of funds.
2. It facilitates in developing a sound capital structure which gives maximum returns to shareholders.
3. It helps in proper utilisation of funds.
4. It tries to avoid the shortage of funds and surplus of funds.
5. It provides policies and procedures for coordinating different departments of an enterprise.
6. It acts as a basis to control the financial activities of an organisation.
7. It helps to face unforeseen financial situations in the business.

INTEXT QUESTION 10.3

1. Which of the following are not the essential characteristics of financial planning?

   (a) Simplicity

   (b) Liquidity

   (c) Abundant availability of funds

   (d) Flexibility

   (e) Concentration on long term needs only

   (f) Economy

2. State whether the following are objectives of financial planning, by writing 'Yes' or 'No'.

   (a) Determining the requirement of fixed and working capital. ( )

   (b) Determining the sales output. ( )

   (c) To ensure the timely availability of funds. ( )

   (d) To determine the quantity of production. ( )

   (e) To raise funds at the lowest possible cost. ( )

10.4 CONCEPT OF CAPITAL STRUCTURE

Broadly speaking, there are two forms of capital:

1. Equity Capital
2. Debt Capital.

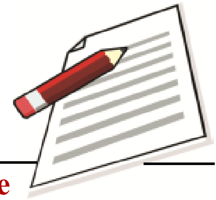
A **Equity Capital:** This refers to money put up in the business and owned by the shareholders (owners). It is costliest source of finance.Typically, equity consists of two types:

1.) Contributed capital, which is the capital that was originally invested in the business in exchange for equity share capital and preference share capital; and

2.) Retained earnings consist of share premium + free reserve + surplus profits + discretionary provisions for contingency + development rebate reserve. It represents profits not distributed as dividend from past years that have been kept by the company and to be used for growth, expansion or acquisitions of the business.

B **Debt Capital:** Debt consists of all borrowings from government, semi-government + statutory corporations and other agencies + term loans from banks and financial institutions + debenture issues + all deferred payment liabilities. Short-term debt such as working capital requirements is also considered to be part of the capital structure.

The capital structure of a firm refers as a choice of that combination of debt and equity, which is used for financing the operations of business and to maximize the market value of the shares of the firm.



10.4.1 PATTERN OF CAPITAL STRUCTURE

Thus, capital structure refers to the proportions or combinations of equity share capital, preference share capital, debentures, long-term loans, retained earnings and other long-term sources of funds in the total amount of capital which a firm should raise to run its business.

When a company is analyzing what capital structure to adopt it can opt for:

(i) Capital structure with equity shares only

(ii) Capital structure with equity and preference shares

(iii) Capital structure with equity shares and debentures

(iv) Capital structure with equity, preference shares and debentures

10.4.2 COST AND RISK OF DEBT AND EQUITY

Debt and equity differ in cost and risk. Debt involves less cost as interest paid on debt is treated as a revenue expense and is subject to tax-shield, but it is risky because payment of regular interest on debt is a legal obligation for the business. In case the company fails to pay debt, debenture holders can claim over the assets of the company and if company fails to honour interest payment, it can even go to liquidation and stage of insolvency.

Equity securities are safe securities from company's point of view as company has no legal obligation to pay dividend to equity shareholders even if company is running on profit or loss but equity are expensive as payment of dividend is not subject to tax-shield and their expectation of return is high as well as the company has no legal obligation to pay their capital contribution during the life of the company as they are owners. Equity shareholders will only get their capital after the winding-up of the company as a last piece of the cake.

10.4.3 DIFFERENCE BETWEEN CAPITAL STRUCTURE AND FINANCIAL STRUCTURE

1. Capital structure includes non-current liabilities whereas financial structure includes non-current liabilities and current liabilities.

2. Capital Structure consists of shareholders' fund and long-term debt whereas financial structure consists of Shareholders fund, long-term debt and current liabilities.

3. Capital structure refers to the proportion of long-term debt and equity in the total capital of a company whereas financial structure refers to the net worth or

shareholders' fund or owners' equity and all liabilities i.e., long-term and short term.

4. Capital structure of a company is a part of its financial structure whereas financial structure comprises capital structure and current liabilities.

5. Capital structure does not include short-term or current liabilities whereas financial structure is the sum of long-term as well as short-term liabilities.

10.4.4 DETERMINANTS OF CAPITAL STRUCTURE

The factors which influence the decision of capital structure are:

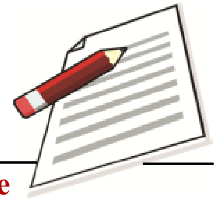
1. **Cash Flow Position:** What should be the mix of debt and equity in the capital structure of a company depends upon its ability to generate enough cash inflows because the company is under legal obligation to pay a fixed rate of interest to debenture holders, dividend to preference shares and principal and interest amount on loan.

2. **Return on Investment:** Return on investment is another crucial factor which helps in deciding the capital structure. If the return on investment is more than rate of interest, company must prefer debt in its capital structure. Whereas, if return on investment is less than rate of return to be paid on debt, then company should avoid debt and rely on equity capital.

3. **Tax Rate:** High tax rate makes debt cheaper as interest paid to provider of debt capital is subject to tax-shield before calculating tax liability whereas company has to pay dividend distribution tax on dividend paid to shareholders. So high rate of tax means it will prefer debt whereas at low tax rate means equity in capital structure.

4. **Cost of Financing:** If a company can manage to borrow funds at low rate of interest, it will prefer more debt as compared to equity. On the other hand, equity shareholders expect a high return on their investment i.e., earnings per share. If by the use of debt, EPS is increasing, then company can include debt in capital structure but when EPS starts decreasing with the inclusion debt then company must depend upon equity shareholder or such combination of debt and equity at which EPS is the highest.

5. **Floatation Costs:** Floatation cost is the cost incurred of the issue of shares or debentures. These costs include the cost of advertisement, underwriting, brokerage, agreement with banks and statutory fees etc. which cannot be ignored. There is less cost involved in procuring capital by loans from financial institutions as compared to public issues.



6. **Risk Consideration:** If a company's business risk is low, then it can raise more capital by issue of debt securities whereas at the time of high business risk, it should depend upon equity.

7. **Flexibility:** To maintain flexibility of raising funds, it must have some scope of borrowing power to take care of unforeseen circumstances because excess of debt may restrict the firm's capacity to borrow further.

8. **Control:** The total control of the company lies in the hand of equity shareholders as they are the owners. The authority to manage the affairs of the company rests on Board of Directors. The debenture holders have no say in the management and preference shareholders have limited right to vote in the annual general meeting.

9. **Interest Coverage Ratio:** High interest coverage ratio means the company can have more of borrowed fund securities whereas lower interest coverage ratio means less borrowed fund securities.

10. **Debt Service Coverage Ratio:** If debt service coverage ratio is high, then company can have more debt in capital structure as it indicates ability of the company to repay its debt but if debt service coverage ratio is less, it indicates that company must avoid debt and depend upon equity capital only.

11. **Regulatory Framework:** A company issues shares and debentures within the SEBI guidelines and takes loans. If the monetary policies are more flexible, then they may go for more of loans whereas if SEBI guidelines are easy, then company may prefer issue of financial assets for additional capital.

12. **Stock Market Condition:** Stock market works under two conditions i.e., Boom and Recession condition which affect the capital structure especially when company is planning to raise additional capital as investors may be more careful in their dealings.During the period of boom, business is flourishing and investors dare to take risks and prefer to invest in equity shares to earn more return in the form of dividend and capital appreciation whereas in recession, the stock market business is slow and investors are shaky to take risks. Hence, it is advisable to issue fixed interest bearing securities as these are less risky and ensure fixed payment and regular payment of interest.

INTEXT QUESTION 10.4

1. Balance Sheet of a company is given as under:

Liabilities	Amount (₹)	Assets	Amount (₹)
A Non-Current Liabilities:		A. Non-current Assets	
(a) Shareholder's fund:		(a) Fixed Assets:	
(i) Equity share capital	10,000	(i) Land & buildings	15,000
(ii) Reserve and Surplus	5,000	(ii) Plant & machinery	20,000
General Reserve 4,000		(iii) Furniture, fixture & fittings	5,000
Retained earnings 1,000			
(b) 15% Preference Share Capital	2,000	(b) Intangible Assets:	
		Patent, copyright, trademark	5000
(c) 12% Debentures	15,000	(c) Wasting Assets (oil well,)	5000
(d) Long term loans	10,000		
(e) Working Capital loans	3,000		
B. Current Liabilities:		B. Current Assets:	10,000
i. Sundry trade Creditors	10,000	(i) Inventories	6,000
ii. Short -term loans	5,000	(ii) Debtors	2,500
iii. Bank overdraft	5,000	(iii) Cash in hand	1,000
iv. Cash credit	4,000	(iv) Cash in bank	500
v. Outstanding expenses	1,000	(v) Prepaid expenses	
Total	70,000		70,000

You are required to find out (a) Equity fund; (b) Debt fund; (c) Capital Structure; (d) Financial structure

2. A high geared company is exposed to:

   (a) Business risk (b) financial risk (c) inflation risk (d) all of the above

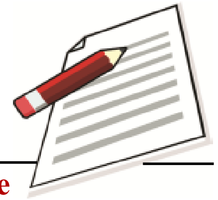
3. High level of gearing means

   (a) Proportion of long-term debt to shareholder's funds is low.

(b) Proportion of long-term assets to shareholder's funds is high.

(c) Proportion of fixed assets to total assets is high.

(d) Proportion of loan funds to net worth is high.



10.5 LEVERAGE

You often hear your friends and co-worker say that they are overburdened with work to achieve the sales target. Why does it happen? It happens because of the excessive sales target given to the sales personnel by the sales manager who knows the leverage of its company through which they can minimize risk of incurring loss and losing market share. Hence, knowledge of business leverage of its own company and competitors' firm will provide opportunities to your company to take a business lead while making a decision about how much to generate sales revenue and how much fund is required.

The word 'leverage' has been derived from the word 'lever' which refers to a device through which you can lift more weight with minimum efforts.

Like-wise in business, leverage (sometimes referred to as gearing) refers to the use of a significant amount of debt and/or credit to purchase an asset, operate a company, acquire another company, etc. with the expectation that the after-tax profit to equity holders from the transaction will exceed the borrowing cost which means increased earnings per share.Leverage refers to the capacity of a firm to employ more debt in the capital structure of the firm to maximize the EPS and to enhance returns to the owner as the cost of obtaining debt is cheap as compared to equity and minimize the cost of capital. That's why every firm tries to minimize cost of capital by incorporating more and more debt in its capital structure.

10.5.1 TYPES OF LEVERAGE

It can be classified into three categories:

(a) **Financial Leverage:** If you can envision a balance sheet of a company, financial leverage refers to the left-hand side of the balance sheet. Financial leverage refers to how the firm will pay for it or how the operation will be financed.

Financial Leverage: refers to the amount of debt in the capital structure of the business firm.This measures the financial risk which arises due to high charge of interest due to excessive use of debt component.It is the company's ability to use fixed financial changes to magnify the effect of changes in EBIT on the company's EPS.A high financial leverage indicates a higher percentage of debt in the capital structure. It magnifies the returns from our debt financing.

Financial Leverage= Earnings before interest and tax (EBIT)/ earnings before tax EBIT

(b) **Operating Leverage:** There are essentially two types of costs in a company's cost structure - fixed costs and variable costs. Operating leverage is the ratio of

fixed costs to variable costs. If a business firm has a lot of fixed costs as compared to variable costs, then the firm is said to expose to operating leverage which measures the business risk or operating risk, i.e., variability of EBIT due to fluctuation in sales revenue. It means that if a firm has high operating leverage, a small change in sales volume results in a large change in Earnings before Interest and Tax and Return on Invested Capital. It magnifies the returns from our plant and equipment or fixed assets.

Operating Leverage= Contribution/ Earnings before interest and tax (EBIT)

(c) **Combined Leverage:** It indicates the effect of sales volume on the EPS of the firm. It is the relationship between Contribution and EBT. A higher combined leverage indicates the firm is subject to greater risk which includes both business risk and financial risk. It can be also found out by multiplying operating leverage and financial leverage.

Combined Leverage = Contribution/EBT

or

Combined Leverage = Financial leverage × operating leverage.

Suppose, if operating leverage is 2 and financial leverage is 5, then combined leverage will be 10. It describes that if there is increase of 1% in sales revenue, then earnings before tax or profit before tax will increase by 10% and vice-versa.

10.5.2 THE COMBINED EFFECT OF OPERATING LEVERAGE AND FINANCIAL LEVERAGE

	Operating leverage	Financial leverage	Effect
1.	High	High	Very risky, high interest outflow
2.	High	Low	Sales still unsatisfactory in relation to the fixed costs to be absorbed.
3.	Low	High	Ideal situation for profit maximization
4.	Low	Low	Management over- cautious or risk averse

INTEXT QUESTION 10.5

1. From the following information, calculate: (a) Operating Leverage; (b) Financial leverage; and (c) combined leverage.

Items		Amount (₹)
1.	Sales revenue (2,000 units @ ₹ 5 each)	10,000
2.	Less: Variable cost (2,000 units @ ₹ 2 each)	4,000
3.	Contribution (1-2)	6,000
4.	Less: operating fixed cost	2,000
5.	EBIT or Operating profit or Earning before interest and tax [3-4]	4,000
6.	Less: Interest paid on borrowings	2,000
7.	Earning before tax (EBT) [5-6]	2,000

2. A company produced and sold 20,000 units with a variable cost of Rs.20 per unit and Rs.30 per unit as selling price. The fixed overheads during the period was Rs.1,00,000. The operating leverage of the company is:

   (a) 1 (b) 2 (c) 1.5 (d) 2.5

3. If the operating leverage is 3 and financial leverage is 2, the combined leverage is?

   (a) 1 (b) 2.5 (c) 4 (d) 6

4. If combined leverage is 5 and operating leverage is 2, then the financial leverage is:

   (a) 3 (b) 4 (c) 5 (d) 2.5

10.6 FIXED CAPITAL REQUIREMENT

When you are willing to start any business venture, you will require initially two types of capital; First fixed capital and second working capital. It is to be kept in view that fixed capital and working capital, both are imperative for a business to run and perpetuate.

Fixed capital is used to acquire non-current assets (fixed assets) which would serve the business for more than one accounting period. Usually it is present in the form of tangible fixed assets like plant and machinery, factory's land and its buildings, company's

headquarter and offices, buildings, computing and communication infrastructures and investment in intangible assets like patents, copyrights, goodwill etc.

In simple words, capital invested in the acquisition of fixed assets that are durable in nature and whose benefits can be derived over a long period of time, is called as fixed capital. Investment in fixed assets, as part of the total capital investment, is a promising vehicle, for manufacturing goods which later on can be sold for increasing earnings.

10.6.1 FEATURES OF FIXED CAPITAL

(i) It is a compulsory initial investment made in the business.

(ii) It is a part of total capital invested in the business.

(iii) It has a permanent existence in the business to meet its long-term needs.

(iv) It is used for purchasing tangible physical assets and intangible assets.

(v) It is required for promoting the business, like huge advertising campaign.

(vi) It is also required for expansion, modernisation and diversification of business.

10.6.2 SOURCES OF FIXED CAPITAL OR LONG-TERM FINANCE

1. **Issue of Share:** It is the most important source of fixed capital. Generally, there are two types of shares as has been discussed in previous module.

   (a) Equity share and (b) Preference share

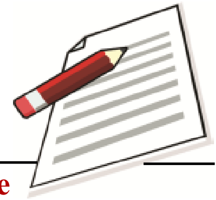
2. **Issue of Right Shares:** When a company decides to issue further share, it is first issued to its existing shareholders at a price below the market price. The share capital increases but the number of shareholders does not increase. Generally, rights issue is very economical to collect fixed capital.

3. **Private Placement of Shares:** It means the company sells its shares directly to a small group of investors like bank, financial institutions, mutual funds etc.

4. **Issue of Debentures:** It represents the borrowed capital of the company and holder of debenture gets interest on investment in debenture at predetermined stated rate.

5. **Term Loans:** The company gets term loans from banks and financial institutions like HDFC, ICICI etc by submitting its project analysis report.

6. **Retained Earnings:** It is a part of undistributed profits earned by the company. This saved profit is called as ploughing back of profits.



7. **Lease Financing:** Under lease financing, lessor who is the owner of assets gives the assets on a lease-basis to the lessee and charges lease rent for using that assets.

10.6.3 DETERMINANTS OF FIXED CAPITAL REQUIREMENT

The factors affecting determination of fixed capital requirements of a business are as under:

1. **Nature of Business:** A manufacturing concern needs more fixed capital as compared to a trading concern as the investment in fixed assets is more in case of manufacturing enterprise.

2. **Size of Business:** It can be tiny, small, medium or large scale industries. The parameters while evaluating the size of business are: turnover of business; capital invested; comparing the market share of business etc. Thus, company form of business requires more fixed capital as compared to partnership firms and sole proprietorship.

3. **Scale of Operation:** It signifies the volume in which a production occurs followed by its successful sale in the market. Generally, the scale of operation will be large if availability of fixed capital is more and vice-versa.

4. **Use of Technology:** Companies using labour-intensive techniques require less fixed capital as compared to capital-intensive companies.

5. **Types of Products Manufactured:** Companies manufacturing simple products like paper clips will need less amount of fixed capital as compared to companies manufacturing complex products like industrial products.

6. **Scope of Activities:** If scope of business is vast, it needs higher fixed capital such as manufacturing, processing and assembling as compared to those whose scope is limited requires less amount of fixed capital such as company does only assembling activities.

7. **Method of Acquiring Assets:** If the assets are acquired on a rental or lease basis it requires less fixed capital as compared to instalment purchase basis and direct cash purchase basis.

8. **Government Subsidy:** It means financial assistance allocated to needy companies on certain terms and conditions as framed by the government. Generally, companies operating in backward areas get concession or subsidy for purchasing fixed assets (requires less amount of fixed capital) whereas

companies operating in developed areas do not get any subsidy even though they need more fixed capital.

10.6.4 DETERMINATION OR ESTIMATING FIXED CAPITAL REQUIREMENT

Estimating the requirement of fixed capital is quite complicated work because it requires a complete knowledge of the fundamentals of finance; market and continuous practice without which one will not succeed in estimating the required amount of fixed capital. The amount invested in fixed assets is termed as fixed capital and in the language of finance it is termed as capital budgeting which involves two most important estimates i.e., cash outflows and cash inflows. When a new asset is to be bought, it is necessary to estimate the costs involved to buy and to put the asset into production. This is termed as cash outflow or to be precise net cash investment. Simultaneously, the annual cash inflows the project will generate after it goes into operation. So, it is necessary to estimate the internal cash inflows, resulting from the production and sale of the output over the life of the asset. This estimate of cash inflows is called net cash benefits. The following examples will provide you with a blue print in estimating fixed capital requirement.

A- Estimating Fixed Capital Requirement. (Cash Outflows):

	Items	Amount (₹)
1.	(a) Estimated price of fixed assets	100
	+(b) Freight charges or carrying cost	5
	+(c) Installation cost	5
	Total of 1.	110
2.	Add: permanent increase in working capital	20
	Add: Training expenses after adjusting tax rebate, if any	10
	Total of 2	30
3.	Grand Total (1+2)	140
4.	Deduct: Net proceeds from the sale of old fixed assets (salvage value-cost of removal and disposal)	5
5.	Balance (3-4) or Net cash outflows or fixed capital requirement.	135

B- Estimating Net Cash Inflows (from operation to compensate fixed capital)

	Items	Amount (₹)
1.	Income from sales revenue (cash sales plus credit sales assuming it is willfully realized as and when it becomes realizable)	100
2.	Deduct: Cost of goods sold (cash expenses i.e., fixed and variable expenses)	(40)
3.	EBDIT [earnings before depreciation, interest and tax] (1- 2)	60
4.	Now deduct: amount of depreciation of fixed assets	(10)
5.	It is EBIT [earnings before interest and tax] (3 - 4)	50
6.	Now deduct interest payable or paid from 5	(10)
7.	Balance (5 - 6) or EBT [earnings before tax]	40
8.	Now deduct Income-tax payable or paid from 7 say @ 30% on Rs.40	(12)
9.	Balance (7- 8) or EAT [earnings after tax]	28
10.	Add: depreciation in EAT (given in point no. 4)	10
11.	Now it is Cash Inflow as source of fixed capital	38

Thus, the total fixed capital requirement will be equal to Rs. 97 (i.e., outflows ₹ 135 minus inflows ₹ 38)

INTEXT QUESTION 10.6

1. Fill in the blanks by choosing the correct answer.

   (a) When a company sell its shares directly to a small group of investors like bank, financial institutions, mutual funds etc, it is called as ………..(private placement, public issue, right share)

   (b) Retained earnings is an example of……….(fixed capital, current assets, liquid assets).

   (c) Rights issue is very ……….. to collect fixed capital.(economical, expensive, neutral)

   (d) Fixed capital is capital that we invest in …………..(fixed assets,current assets, fictitious assets)

10.7 WORKING CAPITAL

Generally,working capital is an amount used to serve the business on day-to-day basis fulfilling the requirement of everyday production and operation.Working capital can be increased by profitable business operation, sale of long-term assets, long-term borrowing and investment by owners. It can be decreased by unprofitable business operations; purchase of long-term assets without long-term financing, distributing cash to owners. It is also called as circulating capital because most of the amount invested in current assets passes through a cycle as under:

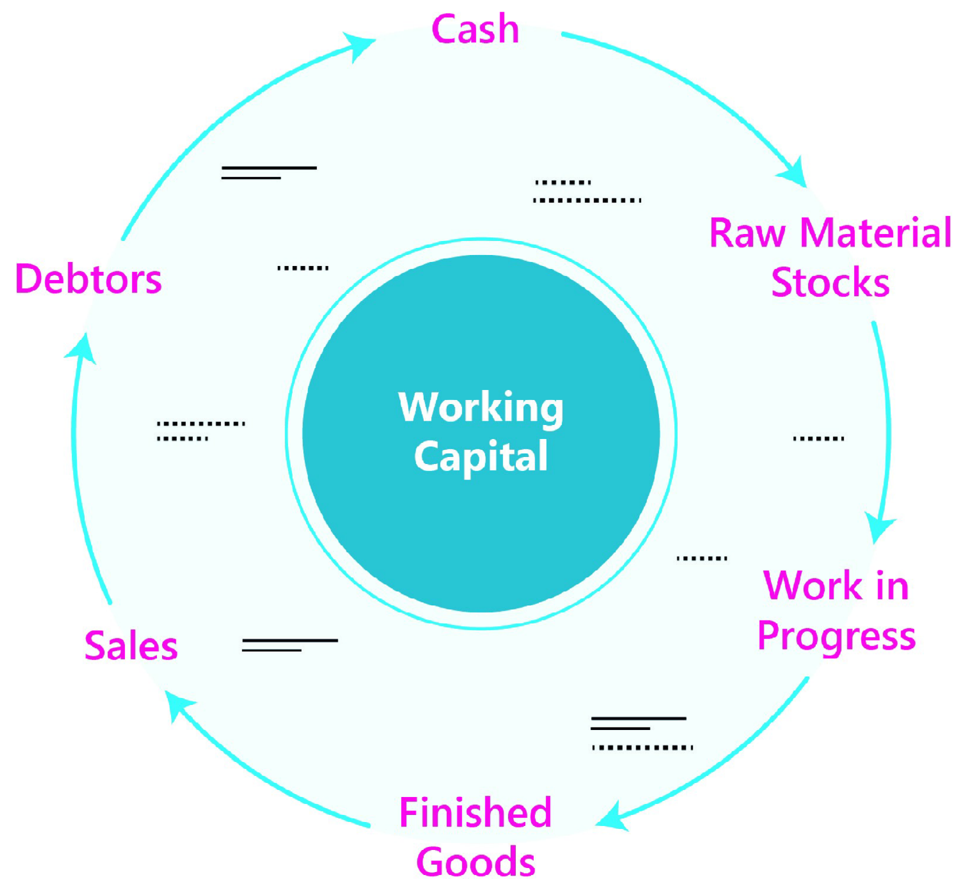
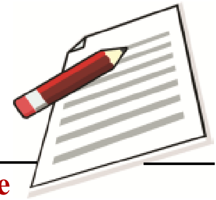


Fig.: 10.2 Working Capital

10.7.1 CONCEPT OF WORKING CAPITAL

The concept of working capital can be understood in two different ways. These are:

(a) **Gross Concept of Working Capital:** It refers to the firm's investment in current assets. Current assets are those assets which can be readily convertible into cash within one accounting period; say 12 months.



Note

(b) **Net Concept of Working Capital:** It refers to the excess of total of current assets over total of current liabilities or refers as current assets minus current liabilities. Current liabilities are those which can be payable within one year.

10.7.2 CHOICE OF THE CONCEPT

Choice of the concepts depends upon the objective of the study. If the objective is to assess the efficiency of the business, then the gross concept of working capital will be suitable. But if the objective is to assess the liquidity position, then net concept will be suitable.

10.7.3 TYPES OF WORKING CAPITAL

Working capital can be classified into two categories;

(a) **Permanent/Fixed Working Capital:** Every firm has to keep a minimum level of investment in current assets or core current assets to ensure the continuity of operations without any interruption which represents minimum levels of inventory, minimum level of amount always tied-up in debtors due to credit policy and reasonable amount of cash to meet the day-to-day working expenses of the business. A firm financesits core current assets in business operation through long-term sources.

(b) **Variable Working Capital:** It is also called as fluctuating working capital. The requirement of variable working capital depends upon the change in production and sales due to change in demand or seasonality of industry such as peak seasons and slump seasons over and above the permanent working capital. A firm finances its fluctuating needs of working capital through short-term debt.

10.7.4 WORKING CAPITAL VS. LIQUIDITY

A retailer, distributor or manufacturer may have a large amount of working capital in current assets. However, if most of its current assets are in slow-moving inventory, the company may not have the liquidity to pay its obligations on the agreed upon due dates. Similarly, if a company is unable to collect its accounts receivable, it may not have the liquidity to pay its obligations.

In contrast, consider a company that sells popular products online and customers pay with bank credit cards or debit cards when they order. Further, the company's suppliers allow the company to pay 60 days after it purchases the products. This company may have very little working capital, but it may have the liquidity it needs.

10.7.5 COMPONENTS OF WORKING CAPITAL

(a) Current Assets

A major component of working capital is current assets. A shortened definition of current assets is: a company's cash plus its other resources that are expected to turn to cash within one year. Example of current assets include:

(i) cash and cash equivalents

(ii) temporary or short-term investments

(iii) accounts receivable or debtors or book-debt

(iv) inventory such as raw materials, semi-finished goods and finished goods

(v) supplies

(vi) prepaid expenses

(b) Current Liabilities

The other major component of working capital is current liabilities. A shortened definition of current liabilities is: a company's obligations that will be due within one year. Examples of current liabilities include:

(i) Loan principal instalment amounts that will be due within one year

(ii) Accounts payable/sundry creditors

(iii) Bank overdraft/cash credit/ short-term loan

(iv) Wages payable

(v) Payroll taxes withheld from employees

(vi) Accrued expenses/liabilities (utilities, repairs, interest, etc.)

(vii) Customer deposits and deferred revenues

10.7.6 DIFFERENCE BETWEEN FIXED CAPITAL AND WORKING CAPITAL

Basis of difference	Fixed Capital	Working Capital
1. Meaning	Fixed capital is the investment done by the business for accruing long-term benefits.	Working capital is the daily requirement pumped into business.
2. Acquiring of assets	Fixed capital is used to acquire non-current assets.	It is used to acquire current assets.
3. Conversion	Can't be converted into cash or kind immediately	Can be converted into cash within one year.
4. Tenure	Serves the business for longer period of time.	Serves the business for short period of time.
5. Benefits	Offer benefits for more than one accounting period	Offer benefits for less than one accounting period.
6. Liquidity	Very low liquidity	High liquidity

10.7.7 DETERMINANTS OF WORKING CAPITAL

A wide variety of factors influence the total investment in working capital in an enterprise. Significant among them are:

1. **Promotional and Formative Phase:** The start-up of a new project and initial years constitute the most crucial phase for planning and provisioning of working capital funds.

2. **Position of Business Cycle:** Movements of the business cycle bring about shifts in working capital position. The upward swing is associated with spurt in sales and increase in levels of inventories and book debts. On the other hand, when there is a downswing, the levels of inventories and book debts may fall, causing cash flux.

3. **Nature of Business:** The nature of business has an important bearing on its working capital needs. For some ventures, such as retail stores, tobacco manufacture, construction companies, etc., the fixed assets become nominal or incidental and they require an abundance of working capital.

4. **The Manufacturing Cycle:** An extended time span, between the raw material

purchase and the completion of the manufacturing process yielding the finished product, will obviously mean a larger tie-up of funds in the form of enhanced working capital needs.

5. **Credit Terms to Customers:** The credit terms granted to customers influence the working capital level by determining the level of investment in book debts. Liberal credit and Slack collection procedures or permissive attitude in the matter of collection of outstanding can also lock up funds that would otherwise be available for operating needs.

6. **Vagaries in Supply of Raw Materials:** Some raw materials may be available only in certain seasons so that these have to be obtained and stored, in advance, for the lean months. The working capital requirements, in such circumstances, will register seasonal fluctuations.

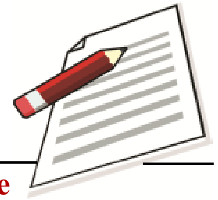
7. **Shift in Demand for Products:** The rising stock levels during the periods of production in excess of demand will require increasing amounts of working capital to be provided and these funds will remain, tied-up in inventories for some months. The financial planning will have to incorporate this pattern of funds requirements associated with steady production and seasonal sales.

8. **Production Policies:** A strategy of steady rate of production policy being maintained throughout the year as against a pronounced seasonal demand for manufactured goods is considered threat to the business. The problem is of finding funds to support the mounting inventory levels of finished goods until they get offloaded in the peak season.

9. **Competitive Conditions:** The degree of competition is an important factor influencing working capital requirements. To win and retain customers it will also be necessary to extend generous credit terms, in keeping with competitor's practices, with very limited discretion in formulating own credit policies. The investment in book debts will, therefore, be of a high order requiring additional funds.

10. **Growth and Expansion Programmes:** As business grows, additional working capital has to be found. There is no simple formula to establish the link between growth in sales and growth in working capital or current assets.

11. **Profit Level:** By the very nature of things, some enterprises generate high gross margins, compared to others. High gross margins improve prospects of a higher rate of internal generation at the completion of each cash cycle which is based on the assumption that the benefit of high gross margin is not lost or dissipated



in expensive enterprise activities in marketing and administrative areas.

12. **Taxation:** Tax liability is an inescapable element in working capital planning. It is a short-term liability payable in cash. Advance tax may have to be remitted in instalments, the computation being based on projected profits for the year. Periods of high taxation impose additional strain on working capital. The finance manager, who is well informed in tax matters, has appreciable scope for tax planning with a view-to reducing the cash drain by way of tax.

13. **Dividend Policy:** Dividend, once declared, is a short-term liability, leading to a cash outgo. There are statutory regulations governing prompt disbursements of dividends due and payable.

14. **Depreciation Policy:** Depreciation policy centres around the determination of the amount to be provided as depreciation charges to make up the ultimate resource for replacement of worn out or obsolete assets. The selection of the method of depreciation has important financial implications. If current capital expenditure falls short of the depreciation provision, working capital position is strengthened and there may be no need for short-term borrowing.

15. **Reserve Policy:** One of the cherished goals of enterprise management is to build up adequate reserves out of profits. Wherever the desire to build up reserves is dominant, working capital or funds position receives priority of consideration and dividends get a residual treatment.

16. **Price Level Changes:** It is also called as inflation. It is true that not all prices move at the same pace. Nor do they all move in the same direction. This diversity in price changes creates contradictions. It leaves some companies relieved of their working capital problems and, at the same time, it aggravates or intensifies the working capital problems of others.

17. **Operating Efficiency:** There is an obvious relationship between the operating efficiency of a company and its working capital position. Efficiency of operations accelerates the pace of the cash cycle, and improves the working capital turnover. It releases the pressure on working capital by improving profitability and aiding added internal generation of funds.

10.7.8 ESTIMATING WORKING CAPITAL REQUIREMENT

The need of working capital aims at maximizing the wealth of its shareholders. In this endeavour, a firm should earn sufficient return from its operations which requires successful sales activities. For which current assets are needed because sales do not convert into cash instantaneously. It involves an operating cycle in conversion of sales

into cash. A firm requires many years to recover the initial investment in fixed assets. On the contrary, investment in current assets is turned over many times in a year leading to less requirement of investment in current assets.

The most appropriate method of estimating the working capital needs is the concept of operating cycle. However, a number of other methods may be used to determine working capital needs. These are:

(a) Current Assets Holding Period Method or Operating Cycle Approach: This method is based on the operating cycle concept. It is the time duration required to convert sales, after the conversion of resources such as cash into inventories, into sales, into debtors and finally into cash. It is depicted as:

Net Operating cycle period =

Inventory conversion period + Debtors(receivable) conversion period

- creditors deferred period.

Working capital needs =[Estimated cost of goods produced X Net operating cycle period] + permanent cash requirement.

(b) Ratio to sales: To estimate working capital needs as a ratio to sales on the assumption that current assets change with sales.

(c) Percentage of fixed investment: To estimate working capital needs as a percentage of fixed investment.

INTEXT QUESTION 10.7

1. Fill in the blanks:

(a) Working capital refers to the excess of current assets over.............

(b) Gross working capital means investment in ....

(c) Liquidity means closeness to..................

(d) Inventory is the component of ....

(e) Payment of loan instalment is ....

(f) Working capital is needed for meeting expenses of the ....business.

2. State whether we require 'more' or 'less' working capital in the following cases:

(a) A company manufacturing Iron & steel.

(b) A bread manufacturing company having high inventory turnover.

(c) A large size business enterprise making toys.

(d) Company manufacturing furniture against orders only.

(e) A company manufacturing coolers/refrigerators.

3. Match the items in column A with column B.

Column A	**Column B**
(a) Fixed Capital	(a) Short term finance
(b) Public utilities	(ii) working capital requirement
(c) Permanent working capital	(iii) long-term finance
(d) Goodwill	(iv) telephone company
(e) Fluctuating working capital	(v) intangible fixed assets
(f) Length of production	(vi) Fixed working capital

4. Balance Sheet of a company is given as under:

Liabilities	**Amount (₹)**	**Assets**	**Amount (₹)**
A Non-Current Liabilities:		A. Non-current Assets	
(a) Shareholder's fund:		(a) Fixed Assets:	
(i) Equity share capita	10,000	(i) Land & buildings	15,000
(ii) Reserve and Surplus	5,000	(ii) Plant & machinery	20,000
General Reserve 4,000		(iii) Furniture, fixture & fittings	5,000
Retained earnings 1,000			
(b) 15% Preference Share Capital	2,000	(b) Intangible Assets:	
		Patent, copyright, trademark	5000
(c) 12% Debentures	15,000	(c) Wasting Assets(oil well,)	5000
(d) Long term loans	10,000		
(e) Working Capital loans	3,000		
B. Current Liabilities:		B. Current Assets:	10,000
i. Sundry trade Creditors	10,000	(i) Inventories	6,000
ii. Short -term loans	5,000	(ii) Debtors	2,500
iii. Bank overdraft	5,000	(iii) Cash in hand	1,000
iv. Cash credit	4,000	(iv) Cash in bank	500
v. Outstanding expenses	1,000	(v) Prepaid expenses	
Total	70,000		70,000

Note

You are required to find out (a) Gross working capital and (b) Net working capital

10.8 DIVIDEND DECISION

You have already learned that dividend decision is also one of the crucial areas of financial management. As you know that the rate of dividend to be payable at the time of raising capital by the issue of preference share is fixed. Therefore, a company must pay dividend to its preference shareholder before paying dividend to equity shareholders. Hence, dividend decision is not concerned with paying dividend to preference shareholders but concerned with paying dividend to equity shareholders.

The important aspect of this decision is to determine how much amount of profit after tax is to be distributed to shareholders and how much amount is to be retained in the company for financing the growth and expansions of the business. Hence, framing of dividend policy involves the balancing of the shareholders' desire for current dividends and the company's need for funds for growth and expansion.

The main objective of a dividend policy should be to maximize the shareholder's return so that the value of his investment is maximized. Shareholders' return consists of dividend income and capital gain.

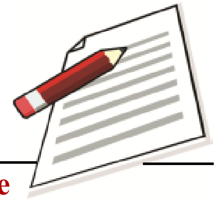
10.8.1 WHAT IS DIVIDEND?

Dividend constitutes the use of company's funds. Dividends are payments made by a company to its shareholder members. It is the portion of profits paid out to stockholders. Paying dividends is not an expense; rather, it is the division of an asset among shareholders.The amount of the dividend is determined every year at the company's annual general meeting, and declared as either a cash amount or a percentage of the company's profit. Once declared, a dividend becomes a liability of the firm. A high dividend yield is considered to be evidence that a stock is underpriced, whereas a low dividend yield is considered evidence that the stock is overpriced.

Holders of preference share get their regular dividend payment at fixed rate on the amount invested in the company out of profit but holders of equity share have no guarantee to receive dividend in spite of profit because it is the discretionary power of Board of Directors either to pay or not to pay any dividend; equity shareholders can't claim dividend.

10.8.2 MODE OF DIVIDEND PAYMENT

(a) **Cash Dividends:** When a company shares a portion of its net earnings with its shareholders in the form of cash, we call it cash dividend.



(b) **Stock Dividend:** It is also known as bonus shares. A dividend can be paid out in the form of shares of stock. Under the stock dividend issue, the company issues additional shares in a ratio to the investor's current holding. While the number of shares with an investor increases, the market value of the shares remains the same.

(c) **Stock Repurchase:** Under this type of dividend, the existing shareholder gets an option to sell his shares back to the company at a fixed rate. Generally, the fixed rate is higher than the prevailing market rate. It believes that the shares are undervalued. It also helps in reducing the price-to-earnings (P/E) ratio of the share. The earnings per share of the company will also increase.

This way the investor gets some money back in his pocket and the promoters/ management gets higher shares in the company.

10.8.3 DIVIDEND PAYMENT PROCEDURE

(a) **Declaration Date:** The date on which the Board of Directors declare the dividend is called the 'declaration date'.

(b) **Record Date:** A shareholder is eligible to receive the dividend when his or her name is listed in the shareholder's register on 'record date'.

(c) **Payment Date:** The dividend cheques are mailed to shareholders on record.

(d) **Ex-dividend Date:** A share of stock becomes ex-dividend on the date the seller is entitled to keep the dividend. At this point, the stock is said to be trading ex-dividend. The buyer of an ex-dividend stock is not entitled to the next dividend payment.

10.8.4 DETERMINANTS TO DERIVE DIVIDENDS

The dividend to preference shareholders is paid at fixed rate and paid on priority basis i.e., before paying dividend to equity shareholders. The dividend to be paid to equity shareholders is the real issue involved in dividend decision by the management of any company. There are three main factors that may influence a company's dividend decision:

(a) **Free-cash Flow:** The Company simply pays out, as dividends, any cash that is surplus after it invests in all available positive net present value projects.

(b) **Dividend Clientele:** A particular pattern of dividend payments may suit one type of shareholder more than another. A retiree investor may prefer to invest in a company that provides a consistently high dividend yield, whereas a person with a high income bracket from employment may prefer to avoid dividends due

to their high marginal tax rate on income. Although, dividend income received from an Indian company is exempt in the hands of shareholders either paid in the form of cash or bonus share until and unless sold out. If clientele exists for particular patterns of dividend payments, a company may be able to maximise its share price and minimise its cost of capital by catering to a particular clientele. Thus, this may lead to payment of relatively consistent dividend.

(c) **Information Signalling:** Dividend announcements convey information to investors regarding the company's future prospects. Suppose, if a company declared very high dividends, it gives a signal to prospective and present investors that the company has no future investment opportunities and vice-versa which decreases or increases the market price of the share. It is due to the information content of dividends.

INTEXT QUESTION 10.8

1. Give the full form of the following abbreviations.

   (a) PAT (b) FBT (c) EBIT

2. In a company form of business, the wealth created is reflected in the________________ of its shares.

   (a) Dividends declared

   (b) Dividend growth

   (c) Market value

   (d) Assets value

3. The dividend decisions are concerned with:

   (a) Determination of quantum of profits to be distributed to the owners

   (b) The frequency of such payments

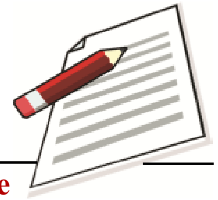
   (c) The amounts to be retained by the company

   (d) All of the above.

4. The buyer of an ex-dividend stock is not entitled to the ____________payment:

   (a) Next dividend

   (b) Current divided



(c) Past dividend

(d) None of the above

5. Paying dividend is ________________

(a) Not an expenses

(b) The division of an asset

(c) An inflows of funds

(d) All of the above

6. A________________is a payment of additional shares to shareholders in lieu of cash.

(a) Split dividend.

(b) Stock dividend

(c) Regular dividend

(d) Extra dividend

TERMINAL EXERCISE

A. Very Short Answer Questions

1. What do you understand by financing decision?
2. What do you understand by dividend decision?
3. What do you understand by investment decision?
4. What is meant by financial planning?
5. State the components of working capital.
6. Describe the components of debt and equity.
7. Explain the importance of information signaling in dividend decision.

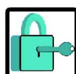
B. Short Answer Questions

1. Critically examine the objective of financial management.
2. Explain the concept of working capital and its choice.
3. State the sources of fixed capital.
4. Explain capital structure and its components.

5. Explain the cost and risk associated with equity and debt capital.
6. State any four objectives of financial planning.
7. Explain the different modes of dividend payments.
8. Differentite between fixed capital and working capital.
9. Distinguish between capital structure and financial structure.

C. Long Answer Questions

1. What is meant by 'Financial Planning'? Explain any four requisites of a sound financial plan.
2. How does raising of long term funds through debt affect the return on shareholders' funds? Explain with an example.
3. What is meant by 'dividend'? State the factors that affect dividend decision.
4. How do you assess the amount of working capital required by a business unit? Describe in brief.
5. "Financial management is much more than mere procurement of funds." Explain.
6. What is meant by the term 'leverage'? State the different types of leverages.



ANSWERS TO INTEXT QUESTIONS

10.1 1.(a) 2.(c) 3.(c) 4.(a) 5.(d)

10.2 1.(c) 2.(a)

10.3 1.(a), (c),(e) 2(a). No (b). No (c). Yes (d). NO (E). Yes

3(a). Yes(b). No (c). Yes (d). No (e). Yes

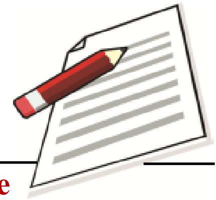
10.4 1. (a) Rs. 17,000 (b) Rs.28,000 (c) Rs.45,000 (d)Rs.70,000

2. (b) 3. (d)

10.5 1. (a) C/EBIT=1.5 (b) EBIT/EBT =2 (c) C/EBT= 3
2. (a) 3.(d) 4.(d)

10.6 (a) private placement (b) fixed capital

(c) economically (d) fixed capital



Note

10.7 1. (a) Current liabilities 1.(b) Current Liabilites 1.(c) Cash

1.(d) Current Assets 1. (e) Current Liabilities 1.(f) operation

2. (a) more (b) less (c) more (d) less (e) more

3.(a) -(iii)(b)-(iv) (c)-(vi) (d)-()v (e)-(i) (f)-(ii)

4.(a) Rs.20,000 (b) Rs. 6,000

10.8 1(a). Profit after tax

1(b). Earnings before tax

1(c). Earnings before interest and tax

2.(c) 3.(d) 4.(a) 5.(b) 6.(b)

DO AND LEARN

Pick up any 10 items/products that you and your family use, for example, sugar, furniture, cooler etc. List them and analyse whether each of them require huge or less working capital for production and why?

S.No.	Product/item	Working Capital need More/ Less	Reasons
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10			

ROLE PLAY

Kanishk is successfully running a manufacturing unit of plastic bottles. He wants to diversify his business to plastic furniture, which requires an additional capital of ₹ 20, 00,000. Currently he has an increasing sales, but still he is in a fix that what other factors he should consider while making a final decision. He approaches his friend who is a financial expert for guiding him.

Dramatise the above situation in the form of a role play assuming the various factors to be considered while making a long term investment decision.

WHAT HAVE YOU LEARNT