# 17

# FINANCIAL PLANNING

You know that every business unit whether it is an industrial establishment, a trading concern or a construction company needs funds for carrying on its activities successfully. It requires funds to acquire fixed assets like machines, equipments, furnitures etc. and to purchase raw materials or finished goods, to pay its creditors, to meet its day-to-day expenses, and so on. In fact, availability of adequate finance is one of the most important factors for success in any business. However, the requirement of finance, now-a-days, is so large that no individual is in a position to provide the whole amount from his personal sources. So the businessman has to depend on other sources and use various ways to raise the necessary amount of funds. In the previous lessons you learnt about the sources and methods of raising funds. You know that the process of raising funds require considerable amount of time and cost. This has its own costs. Hence, every businessman has to be very careful not only in assessing the firm's requirement of finance but also in deciding on the forms in which funds are raised and utilised. In this lesson, you will learn about the process of estimating the firm's **financial requirement** and deciding on the **pattern of finance.**

## OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning and objectives of financial planning;
- explain the concepts of fixed and working capital;
- identify the determinants of fixed and working capital;
- describe the concepts of capitalisation, over-capitalisation and under-capitalisation;
- explain the meaning and importance of capital structure;
- identify the determinants of capital structure; and
- explain the meaning and factors in determining dividend.

Notes

## 17.1 Financial Planning

You know that planning is a systematic way of deciding about and doing things in a purposeful manner. When this approach is applied exclusively for financial matter, it is termed as financial planning. In connection with any business enterprise, it refers to the process of estimating a firm's financial requirements and determining pattern of financing. It includes determing the objectives, policies, procedures and programmes to deal with financial activities. Thus, financial planning involves:

(a) estimating the amount of capital to be raised;

(b) determining the pattern of financing i.e., deciding on the form and proportion of capital to be raised;

(c) and formulating the financial policies and procedures for procurement, allocation and effective utilisation of funds.

After knowing what is financial planning let us now learn its objectives.

### 17.1.1 Objectives of Financial Planning

The main objectives of financial planning are:

(a) To ascertain the amount of fixed capital as well as the working capital required in a given period;

(b) To determine the amount to be raised through various sources using a judicious debt-equity mix;

(c) To ensure that the required amount is raised on time at the lowest possible cost;

(d) To ensure adequate liquidity so that there are no defaults in payments and all contingencies (any unforseen expenditure) are met without difficulty; and

(e) To ensure optimal use of funds so that the business is neither starved of funds nor has unnecessary surplus funds at any point of time.

### 17.1.2 Essentials of a Sound Financial Plan

While preparing a financial plan for any business unit, the following aspects should be kept in view so as to ensure the success of such exercise in meeting the organisational 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 market. But it is considered better to confine to equity shares and simple fixed interest debentures.

(b) **It must take a long term view.** While estimating the capital needs of a firm and raising the required funds, a long-term view is necessary. 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.** While the financial plan is based on long term view, one may not 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. Hence, it is very necessary that the financial plan is capable of being adjusted and revised without any difficulty and delay so as to meet the requirements of the changed circumstances.

(d) **It must ensure optimal use of funds**. The plan should provide for raising reasonable amount of funds. As stated earlier, the business should neither be starved of funds nor have surplus funds. It must be strictly need based and every rupee raised should be effectively utilised. There should be no idle funds.

(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 funds raised is reasonable. The plan should provide for a **financial mix** (combination of debt and equity) that is most economical in terms of cost of capital, otherwise it will adversely affect the return on shareholders' funds.

(f) **Adequate liquidity must be ensured**. Liquidity refers to the ability of a firm to make available the necessary amount of cash as and when required. 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 so planned that some of these can be converted into cash to meet all possible eventualities.

## INTEXT QUESTIONS 17A

1. Define 'Financial Planning' in your own words.

   ______________________________________________

   ______________________________________________

   ______________________________________________

2. Which of the following are not the essential characterstics of financial planning?

   (a) Simplicity

   (b) Liquidity

   (c) Abudant availability of funds

   (d) Flexibility

   (e) Concentration on long term needs only

   (f) Economy

3. 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. ( )

## 17.2 Types of Capital Requirement

The capital requirement of any business unit can be broadly divided into two categories: (a) fixed capital requirement, and (b) working capital requirement. In order to ascertain the amounts of such requirements for any business, one must understand the exact nature of fixed and working capitals and also the various factors that influence their requirement.

### 17.2.1 Fixed Capital

Fixed capital represents the requirement of capital for meeting the permanent or long-term financial needs of the business. It is primarily used for acquiring the fixed assets like land and buildings, plant and machinery, office equipment, furniture and fixtures etc. Fixed capital is required not only while establishing a new enterprise but also for meeting expansion requirement in the existing enterprises. The amount of such requirement can be assessed by preparing a list of fixed assets needed by the business unit and ascertaining their prices from the market.

It may be noted that investment in fixed assets is a long-term commitment and the amount so invested cannot be withdrawn quickly. Hence, the funds for such requirement are always provided from owners' fund or raised by issuing shares and debentures and taking long-term loans from financial institutions.

### 17.2.2 Factors Determining Fixed Capital Requirement

In order to assess the fixed capital requirement for any business enterprise, one must be fully conversant with the factors that influence such requirement. These factors are summarised as follows:

(a) **Nature of business:** The amount of fixed capital requirement is determined primarily by the nature of business the firm is engaged in. Such requirement, for example, is very large in case of industrial establishments, shipping companies, public utilities, etc. which involve heavy investment in plant and machinery. The trading concerns (wholesalers and retailers) do not require much investment in the fixed assets.

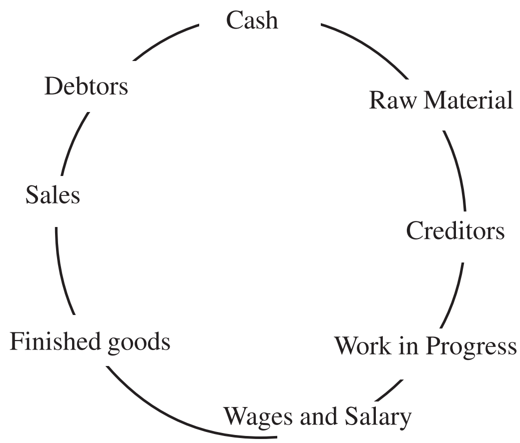
(b) **Type of products:** It is not only the nature of business which determines the requirement of fixed capital but also the type of product involved. A firm manufacturing simple products like soap, toothpaste, stationery, etc. requires small amount of fixed capital as against the firms producing items like steel, cement, automobiles, etc.

(c) **Size of business:** A firm working on a large scale requires heavy investment in fixed assets as it has to establish large production capacity. Hence, its fixed capital requirement is larger than a firm which is operating on a small scale.

(d) **Process of Production:** A firm which goes in for an automatic plant requires larger amount of fixed capital as compared to the firm which selects semi-automatic plant or depends more on manual labour for production of goods. Similarly, if a firm decides to buy most of the components needed for its products from the market rather than producing these in its own factory, it would need less fixed capital as compared to the one which manufactures each component (part) on its own. This is specially true of those automobile and machinery producers who simply act as assembling units.

(e) **Method of acquiring fixed assets:** The fixed assets, specially machinery and equipment, can be acquired either on cash basis (instant payment) or on installments or leasing basis. Apparently, a firm which acquires such assets on cash basis needs larger amount of fixed capital as compared to the firm which decides to acquire it on installment or lease basis.

### 17.2.3 Working Capital



Working Capital Cycle

Working capital represents the amount of funds invested in current assets like debtors, stock-in-trade and cash required for meeting day-to-day expenses, paying wages/salaries to its work-force and clearing dues of its creditors. It is also known as **circulating capital** because most of the amount invested in current assets is continuously recovered through realisations of debtors and cash sale of goods, and is re-invested in current assets. It keeps on revolving from cash to current assets and back again to cash as shown in the working capital cycle here.

It should be noted that a part of working capital is of a permanent nature because depending on the volume of business certain amount of cash, debtors and stock-in-trade shall always be maintained by every firm. This part of working capital is known as **permanent or fixed working capital** and must always be financed through long-term sources. The remaining part of the working capital requirement varies from period to period on account of fluctuations in the volume of business and is called **fluctuating or variable working** capital. This part of working capital is usually financed through short-term sources like bank overdraft, trade creditors, bills payable, etc.

### 17.2.4 Factors Determining Working Capital Requirement

Adequate working capital is very necessary for maintenance of liquidity and running the business smoothly and efficiently. However, the amount of working capital required varies from business to business and from period to period. The various factors that influence such requirement are as follows:

(a) **Nature of business:** The working capital requirement of the manufacturing companies is usually high as they require huge stock-in-trade (inventories) and the amount of their debtors is also expected to be large because of the credit sales involved. As against this, the public utilities like electricity and telephone companies and the concerns like hotels, restaurants, etc. can manage with small amount of working capital as most of their transactions are undertaken on cash basis and their inventory needs are low.

(b) **Size of business:** The size or volume of business plays a major role in determining the amount of working capital requirement of every firm. Obviously, larger the volume of business, larger would be the amount of working capital need. This is because, as their inventory requirement will be large and so also the amount of their debtors.

(c) **Length of production cycle:** Length of production cycle refers to the time period involved in converting raw-material into finished goods. Longer the length of such period, larger will be the requirement of working capital and vice versa. The length of production cycle, however, depends upon the type of product being manufactured and the nature of technology used. For example, in case of products like cars and cotton textiles, the production cycle is much longer than in case of items like stationery, detergents, etc. Therefore working capital requirement is large for car companies and textile mills. Similarly, the firms using updated technology may have shorter production cycles and hence their requirement of working capital may not be large.

(d) **Inventory turnover rate:** Inventory turnover rate refers to the speed at, or the time period within which finished stock is converted into sales. There is a high degree of correlation between the amount of working capital required and the inventory turnover rate. A firm having high inventory turnover rate needs less working capital as against a firm which has low inventory turnover rate. It is so because the firm with high rate can manage with less investment in stock. Take the case of a retailer dealing in fast moving items like groceries and cosmetics with a high turnover rate. Its investment in stock is bound to be much less than a retailer who is dealing in slow moving items like readymade garments or electronics goods.

(e) **Credit policy:** The firms which provide liberal credit facility to their customers need more working capital as compared to those firms which observe strict credit terms and are efficient in realisation of their debts. It is so because when customers enjoy longer period of credit, a larger amount of firm's funds get tied up with debtors. This results in higher requirement of working capital. However, if such a firm also enjoys liberal credit facility from its suppliers, it can manage with lower amount of working capital. But, this may not be true in all cases.

(f) **Seasonal Fluctuations:** The firms that are engaged in manufacturing products like ceiling fans or woollen garments, the demand of which is limited to a specific period of the year, require higher amount of working capital not only during the peak period but also during off season. This is so because they may be left with a good amount of unsold goods which is kept in stock for sale during the next season.

There is no denying the fact that the firms dealing in consumer durables or items involving long production period or wide seasonal fluctuations require large amount of working capital. But, with proper planning and efficient management of inventories and debt collection exercise, the firms can drastically reduce their working capital requirement.

## INTEXT QUESTIONS 17B

1. Mention any two factors that determine Fixed Capital requirement.
   (i) ____________________
   (ii) ____________________
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) A company manufacturing furnitures against orders only. ( )
   (e) A company manufacturing of coolers/refrigerators. ( )
3. Match the items in column A with column B.

| | |
|---|---|
| (a) Fixed capital | (i) 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) Intangile fixed asset |
| (f) Length of production cycle | (vi) Fixed working capital |

## 17.3 CAPITIALISATION

The term capitalisation has various connotations. In common parlance, it refers to the amount at which a company is valued based on its capital employed. Some of the experts on finance used this concept in a narrower sense and defined it as the par value of a company's shares and debentures, while some of them interpreted it as the par value of its total long-term funds which includes owners fund, borrowed funds, reserves and surplus earnings. **In the context of financial planning however, it refers to the process of determining the amount of capital required by a company.**

The capital estimation is arrived at by using the following two theories.

(a) Cost theory; and

(b) Earning theory.

Let us have a brief about these two theories.

**(a) 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.

(b) **Earning Theory:** According to earning theory, the capital requirement of a company is calculated on the basis of the capitalised value of its earning. For example, if the average annual earning of a company is Rs. 5 lakh and the normal rate of return on the capital employed in case of companies in the same industry is 10%, then the amount of capitalisation is Rs. 50 lakh. For a new company the amount of capitalisation is calculated on the basis of its estimated earning. For example, if a new company expects to earn an average annual income of Rs. 3 lakh and the normal rate of return of the industry is 5%, then the amount of capitalisation or the quantum of fund it would require to run the business is Rs. 60 lakh. This approach of capitalisation is considered more rational and relevant because it helps in evaluating as to how far the actual capital employed is justified by the earning of the company. If the actual rate of return is same as the normal rate of return then it is said to be proper capitalised. But in real sense, a company may be either over capitalised or under capitalised that means the actual rate of return may be less or more than the normal rate of return. Let us know in detail about the concept of over-capitalisation and under-capitalisation in the next section.

Capitalisation

Proper Capitalisation | Over-Capitalisation | Under-Capitalisation

### 17.3.1 Over-Capitalisation

$$\frac{2,00,000}{25,00,000}\times 100 = 8\%$$

A company is said to be over-capitalised if its capital employed is more than its proper capitalisation. For example, if a company's average annual earnings is Rs.2,00,000 and the normal rate of return is 10%. Then its proper capitalisation is Rs.20,00,000. Now, if the actual capital employed (total long term funds) is Rs.25,00,000 it will be treated as over-capitalised. You can also put it in another simpler way i.e, if a company's actual rate of earnings is less than the normal rate of return, it is treated as a case of over-capitalisation. In the above example, the company's actual rate of earnings works out as 8%, which is less than the normal rate of return i.e., 10%. So, it is considered as over-capitalised and the company is not in a position to pay interest and dividends at a fair rate. Such a situation may be caused by the following factors:

(a) Excessively high price paid for the purchase of goodwill and other fixed assets.

(b) Underutilisation of production capacity.

(c) Raising more capital in the form of shares and debentures than required.

(d) Liberal dividend policy.

(e) Higher rate of corporate taxation.

(f) Underestimation of capitalisation rate or overestimation of earnings while deciding on the amount of capital to be raised.

Over-capitalisation is not desirable in the long run interest of the shareholders and the company. It leads to lower rate of dividend, reduction in the market value of shares and difficulty in raising more funds. Hence, there is need to rectify such situation as quickly as possible by reducing debt, efficient utilisation of assets, and by following a conservative dividend policy.

| **Effects of Over-capitalisation** | **Remedies of Over-capitalisation** |
|---|---|
| • Lower rate of dividend | • Debts may be redeemed |
| • Reduction in market value of share | • Efficient utilisation of resources |
| • Difficulty in raising additonal funds. | • Conservative dividend policy |

### 17.3.2 Under-Capitalisation

Under-capitalisation is just the reverse of over-capitalisation. In other words, a company is said to be under-capitalised if its capital employed is less than its proper capitalisation i.e., the amount of capital invested is not justified by its annual earnings. In the earlier case, for example, if the company's actual capital employed is Rs. 16,00,000 it shall be treated as under-capitalised as it is less than Rs. 20,00,000, the proper capitalisation. Alternatively, if a company's actual rate of earnings is more than the normal rate of return, it is treated as a case of under-capitalisation. This does not imply that the company suffers from inadequacy of capital.

In fact, such a situation may be the result of underestimation of expected earnings while deciding on the amount of capital to be raised or using low capitalisation rate for the purpose or by following a conservative dividend policy. Of course, improvement in earnings can also be the result of cost reduction exercise or high efficiency. Thus, under-capitalisation is indicative of a sound financial position and may lead to increase in the market value of company's shares. However, it can encourage competition as high rate of return may attract new entrants in the field. The workers of the company may demand for higher wages and other benefits. When the company earns more profit, the customers may feel that they are being over-charged by the company. So, it is better to take corrective steps like capitalisation of profits (issue bonus shares) or splitting up of the shares (a share of Rs.10 may be converted into five shares of Rs. 2 each). Although under-capitlisation is considered a lesser evil than over-capitalisation (as the situation can be remedied more quickly) it is better to ensure a fair or proper capitalisation.

| **Effects of Under-capitalisation** | **Remedies of Under-capitalisation** |
|---|---|
| • Market value of shares goes up since earning are high | • Issue of bonus shares |
| • Workers may demand higher wages | • Splitting up of shares |
| • The high rate of earnings may encourage outsiders to start similar business and thus competition is increased. | • Higher earnings attract competition which ultimately reduces earnings. So the market forces also automatically correct the situation of under-capitalisation. |

## INTEXT QUESTIONS 17C

1. What is meant by the term ‘Capitalisation’?

2. Correct and rewrite the following statements if found incorrect.

   (a) Under-capitalisation may lead to an increase in the price of company’s equity shares in the market.

   (b) Over-capitalisation may be caused by underestimation of capitalisation rate.

   (c) Under-capitalisation refers to a situation when the actual rate of earnings is lower than the normal rate of return.

   (d) Over-capitalisation refers to a situation when the amount of capital employed in a company is more than what is justified by its earnings.

   (e) Over-capitalisation is less harmful than under-capitalisation.

3. The balance sheet of AB Ltd. as on March 31, 2008 is as follows:

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| Share capital | | Fixed assets | 1,00,000 |
| 6,000 equity shares of Rs. 10 each | 60,000 | Current assets | 80,000 |
| Reserves and surplus | 40,000 | | |
| 8% Debentures | 50,000 | | |
| Currents liabilities | 30,000 | | |
| | 1,80,000 | | 1,80,000 |

The earnings of the company from the year 2007-08 were Rs. 18,000 while the normal rate of earnings on capital employed in similar companies is 15%.

Compute (a) its proper or fair capitalisation as justified by the company’s earnings, and (b) state whether it is over-capitalised or under-capitalised.

## 17.4 Capital Structure

The financial requirement of a firm can be met through **ownership** capital and/or **borrowed** capital. The **ownership** capital refers to the amount of capital contributed by the owners. In case of a company, it refers to the amount of funds raised by issuing shares. The main characteristic of the ownership capital is that its contributors are entitled to get dividend out of earnings after the payment of interest and taxes. Hence, the rate of return on such capital depends upon the level of profits earned, and, if there are no profits, no dividend may be paid.

**Borrowed** capital, on the other hand, refers to the amount of funds raised through long term loans and debentures on which its contributors are entitled to a fixed rate of interest which has to be paid at regular intervals (half-yearly or yearly) irrespective of the profits earned. There is also a commitment that the principal amount shall be repaid on maturity. However, it is still considered advantageous to finance business activities through borrowed capital because if the rate of earnings from the planned business investment is expected to be better than the rate of interest on the borrowed funds, it shall ensure higher returns on owners' funds. Let us take an example and understand this concept more clearly.

**Capital Structure**

| | **Illustration - 'A'**<br>**Total Capital Rs. 50 lakh**<br>**(Rs. 20 lakh owners fund+**<br>**Rs. 30 lakh borrowed fund)** | **Illustration - 'B'**<br>**Total Capital Rs. 50 lakh**<br>**(Rs. 50 lakh owners fund+**<br>**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<br>$\left(\frac{\text{PAT}}{\text{Owners'funds}}\times 100\right)$ | $\frac{4,20,000}{20,00,000}\times 100 = 21\%$ | $\frac{6,00,000}{50,00,000}\times 100 = 12\%$ |

Suppose the total investment in a business is Rs. 50 lakh, to which owners contribute Rs.20 lakh and the remaining amount of Rs.30 lakh is funded through loans at 10% interest per annum. Assuming expected annual earnings before interest and tax are Rs. 10 lakh (20% on total investment) the profit after payment of interest but before tax will be Rs.7 lakh (Rs.10 lakh –Rs.3 lakh). Let us assume that the tax is payable on profits at the rate of 40%, the profit after tax will be Rs.4.20 lakh (Rs.7 lakh-

Notes

Rs.2.80 lakh tax) and the return on owners' funds will be 21% . Now, suppose the whole amount of required investment of Rs.50 lakh is contributed by the owners and no loan is taken. Since no interest is payable, the amount of tax will be Rs.4 lakh (40% on Rs.10 lakh) and the profit after tax Rs.6 lakh (Rs.10 lakh – Rs.4 lakh tax). This shall result in 12% return on owner's funds. Thus, you observe that owners get higher return when a part of capital required is funded by borrowings. This is called **'Trading on Equity or Leverage Effect'**. But, there is also an element of risk in using borrowed funds because when the profits decline, interest being a fixed charge, the return on owners' funds is likely to decline. This implies that dependence on borrowings should be kept within reasonable limits. Therefore, most companies generally plan to raise the required amount of long-term funds by using a judicious mix of ownership capital (called equity) and borrowed capital (called debt). **The mix of equity and debt actually used by a company for meeting its requirement of capital is known as its capital structure.** Thus, the term capital structure refers to the make up of a firm's capital in terms of the planned mix of different kinds of long-term funds like equity shares, preference shares, debentures and long term funds. So capital structure involves two basic decisions :

(a) The type of securities to be issued or raised; and

(b) The relative proportion of each type of security.

### 17.4.1 Factors Determining the Capital Structure

You have learnt that the mix of debt and equity used (called the capital structure) for meeting the capital requirements of a company affects the rate of return on owners' capital (shareholders' funds). This in turn, determines the earnings per equity share (EPS) and has its effect on the market value of company's shares. Hence, the choice of an appropriate capital structure becomes a very important decision for the finance manager of any company. He should make this decision on the basis of reliable data and after careful analysis of all the factors that influence this choice. Following are the factors that should be kept in view while deciding on the choice of an appropriate capital structure.

1. **Expected earnings and their stability:** If the expected earnings, in terms of rate of return on the amount to be invested are sufficiently large, use of debt is considered quite desirable. Not only that, the stability of earnings should also be taken into account because if the firm is engaged is business activities in which sales and profits are subject to wide fluctuations, it will be risky to use higher proportion of debt. In other words, if there is an element of uncertainty about the expected earnings it is considered better to rely more on equity share capital. However, with assured prospects of rising earnings, there should be greater reliance on debt so as to take advantage of leverage effect.
2. **Cost of debt :** If the rate of interest on borrowings is lower than the expected rate of return on capital employed, then debt may be preferred. With lower cost of debt financing, the overall cost of financing is reduced and the return on equity capital will be higher, as explained earlier.
3. **Right to manage the business :** You know that the debentureholders and preference shareholders do not have much say in management of the company.

This authority lies primarily with the equity shareholders who have the voting rights. Hence, while deciding on the mix of equity and debt, the promoters/ existing management of the company may also take into account the possible effect of raising funds through equity shares on the right to control the business. In order to retain their right to control the affairs of the company, they may prefer to raise additional funds mainly through debentures and preference shares.

4. **Capital market conditions :** The conditions in the capital market also influence the capital structure decision. At times capital market is so depressed that the investors are unwilling to subscribe to shares. In such a situation, it is considered better to rely on debt or defer the decision till a favourable market condition is restored.

5. **Regulatory norms :** While deciding on the capital structure, the legal constraints like the limit on debt-equity ratio should also be kept in view. At present, such limit is 2:1 in most cases. This implies that at any point of time, the debt should not be more than twice the amount of share capital. This limit keeps on changing with changing economic environment and varies from industry to industry.

6. **Flexibility :** The planned capital structure should be flexible enough to raise additional funds without much difficulty. The company should be able to raise additional capital in the form of debt or equity whenever required. But if the company's capital structure has too much debt, then the lendes may not be able to give more loan to the company. In a such a situation it may be forced to raise the funds only through shares for which the capital market condition may not be conducive. Similarly, when on account of declining business and lack of other investment opportunities the funds need to be refunded, it may not be possible to do so if the company has heavily relied on equity shares which cannot be redeemed easily. Hence, to ensure an element of flexibility, it is better if the firm relies more on redeemable securities that can be paid off if necessary and, at the same time, have some unused debt raising capacity so that future financial needs can be fully taken care of without much difficulty.

7. **Investors' attitude towards investment :** While planning the capital structure of a company one must bear in mind that all investors do not have the same attitude towards their investment. Some are highly conservative who prefer safety to return. For such investors, debentures are considered most suitable. As against this, there are some who are interested in high return on their investments and are ready to take the risk involved. Such investors prefer equity shares. Then, there are many who are willing to take a limited risk provided the return is better than the rate on secured debentures and bonds. Preference shares are most suitable for this category of investors. In order to attract all categories of investors, it is considered more desirable to issue different types of securities specially when the amount of capital requirement is large.

Looking at the above considerations, it can be safely concluded that an appropriate capital structure is one which:

(a) ensures maximum return on equity by making use of the leverage effect within reasonable limits of the risk involved;

(b) caters to all types of investors by using a judicious mix of different types of securities;

(c) has the necessary flexibility to make required reduction or addition to funds, according to changed conditions;

(d) involves minimum risk of dilution in control of the company affairs by the existing group of shareholders; and

(e) fully keeps in view the legal constraints and the prevailing capital market conditions.

To sum up, the most judicious capital structure is one that minimises the cost of funds and maximises the shareholders wealth. In financial management terminology, such a capital structure is called **optimal capital structure.**

## INTEXT QUESTIONS 17D

1. Why do you need flexibility in capital structure?

______________________________________________

______________________________________________

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2. Which of the following are characteristics of an appropriate capital structure? Indicate, by writing YES or NO in the space provided. Rewrite the statements where your answers is NO.

(a) It involves a judicious mix of different types of securities. (   )

______________________________________

(b) It involves dilution of control of existing shareholders. (   )

______________________________________

(c) It caters to exclusively to the wealthy investors. (   )

______________________________________

(d) It ensures minimum return on equity. (   )

______________________________________

(e) It keeps in view the legal constraints. (   )

______________________________________

(f) It has rigidity and firmness and does not change with changed conditions.(   )

______________________________________

## 17.5 DIVIDEND

You know that in every business unit the amount of profit earned (or loss incurred) during a financial year is ascertained and distributed among its owners. In case of a proprietary concern, the whole amount of profit or loss so ascertained is added to proprietor's capital and whatever amount is withdrawn by him is termed as drawings and is deducted from his capital. Similarly, incase of a partnership firm the profit or loss is distributed among the partners in their agreed profit sharing ratio and included in their capital. Whatever amount is withdrawn by the partners is deducted from their respective capitals as drawings. In case of a company, however, it is dealt with differently. First of all we work out the operating profits (called PBIT – Profit before interest and tax). Then deduct the amount of interest on loans therefrom and arrive at the amount of profits before tax (PBT). Then we deduct the amount of tax on the company's profits as per rules and ascertain the profit after tax (PAT). This is the amount of profit which is available for distribution among the shareholders. As a matter of practice and financial prudence, the whole amount of profit earned by the company is never distributed to the shareholders. A substantial part of it, is retained for meeting company's future financial needs. The amount of profits so retained is called **'retained earnings'** and the amount profit distributed to the shareholders is called as **'dividend'**. It may be noted that the dividend paid to preference shareholders is called 'preference dividend' and the dividend paid to equity shareholders is called 'equity dividend'.

### 17.5.1 Factors Affecting Dividend Decisions

The dividend to preference shareholders is paid at fixed rate and paid on priority basis i.e., before making payment 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. Such a decision is guided by the following factors:

1. **Financial needs of the company:** While deciding the amount of dividend to be paid, the management must take into account the financial needs for normal growth of its business, the expansion activities, the repayment of long term debt, etc. Even otherwise, the company must retain a part of profits for long term solvency and meeting future contingencies.
2. **Liquidity requirement:** The payment of dividend involves out flow of cash. At times, a company may have high profits but not much cash. In such a situation, it may not declare high rate of dividend. Even otherwise, liquidity requirement for ensuring timely payment of all dues and debts has to be kept in view while determining the rate of dividend. Such a consideration is of greater importance in case of a growing concern whose liquidity needs may be large on account of its expansion activities and growing working capital requirement, and therefore, they would prefer low payout.
3. **Access to capital market:** A company which, by virtue of its record of profitability and timely repayment of debt, has better access to capital market i.e., it can successfully raise funds by issuing shares and debentures through the capital market, may pay higher dividends. But, if a company does not have easy access to capital markets because of its weak financial position or low profitability record, it cannot afford to pay high dividends. However, when capital market condition is unfavourable most companies shall adopt a conservative dividend policy.

4. **Expectations of shareholders:** The equity shareholders normally look forward to appreciation to their capital rather than higher rate of dividend. But, some shareholders like retired persons or employees do look forward to dividend as a source of their regular income. So, the companies cannot ignore such segment and pay low dividend or skip it even when there are high profits. A reasonable payout is always welcome. In fact, the companies which skip payment of dividend or pay too low rate of dividend as a matter of practice, are rated low in the capital market as the shareholders suspect their management's intentions.

5. **Tax policy:** In our country, dividends have been taxable in the hands of shareholders. Hence, the companies prefer to pay low amount of dividend and issue bonus shares to the shareholders from time to time as these are not taxable until these are sold. If these are sold after 12 months, the sale proceeds are regarded as long term capital gain and taxed at a lower rate. However, of late, the government has changed its policy of taxation of dividends. The dividends are not taxable in the hands of shareholders. But the company has to pay some additional tax (12.5%) on the distributed part of its profits. So, the companies have now become liberal in the matter of dividend distribution.

6. **Investment opportunities and growth prospects:** When a company has adequate profitable investment opportunities and growth prospects, it may prefer to retain more profits and pay low rate of dividends so as to serve the shareholders in a better way in long run. Of course, in the absence of such possibilities, companies prefer payment of higher dividend and avoid idle cash with them.

7. **Legal constraints:** Sometimes, the government prescribes certain limits on the dividend payout which has to be kept in view while deciding on the rate of dividend to be paid. Similarly, at times the long term fund providers may put some restrictions on the dividend payout as part of their agreement. The companies have to adhere to such limits. In any case, the Company Law has provided certain rules to be followed while deciding on the amount to be distributed as dividend. For example, capital profits are not to be used for distribution of dividend normally; a banking company has to transfer certain percentage of profit to a statutory reserve which is not available for payment of dividend, and so on. These have to be duly abided while determining the amount to be distributed as dividend.

## INTEXT QUESTIONS 17E

1. Give the full form of the following abbreviations.

   (a) PAT ____________ (b) PBT ____________ (c) PBIT ____________

2. List any five factors affecting the dividend decision of a company:

   (a) ____________________ (d) ____________________

   (b) ____________________ (e) ____________________

   (c) ____________________

3. State the meaning of the following terms in the space provided.

   (a) Dividend : ________________________________

(b) Retained Earnings: ____________________

(c) Preference Dividend : ____________________

(d) Equity Dividend : ____________________

## 17.6 WHAT YOU HAVE LEARNT

- Adequate and proper financing is quite important for success in any business. While the overall managerial activity of handling finance is called 'Financial management', the process of estimating the financial requirement, determining the pattern of financing and formulating financial policies and procedures is termed as 'Financial planning'. To achieve the objectives of financial planning effectively, it must be ensured that the financial plan is simple, takes a long-term view, has the necessary flexibility to meet changing financial needs of the organisation, provides for reasonable amount at the lowest possible cost, and takes care of the liquidity requirement of the company.
- The firm's capital requirement can be broadly divided into fixed capital and working capital requirements. Fixed capital represents the requirement of capital for permanent or long-term financial needs of the business. Such requirement depends upon the nature of business, size of business, product involved, type of production process adopted, method of acquiring the fixed assets such as cash basis, installment payment method or lease basis. Fixed capital is funded through long-term sources of finance.
- Working capital represents the amount of funds required for financing current assets. A part of the working capital requirement is of a permanent/fixed nature which has to be funded through long-term sources. But the major part of working capital is fluctuating in nature which varies with fluctuations in the volume of business from time to time and is funded through short term sources like bank overdraft, suppliers' credit, etc. The working capital requirement is determined by the nature of business, size of business, length of production cycle, inventory turnover rate, firm's credit policy for its customers and seasonal fluctuations.
- The term 'capitalisation' is used in various contexts. In the context of financial planning, it refers to the process of determining the amount of capital required by the business which may be ascertained on the basis of cost theory or earnings theory.
- Actual capital employed by a firm must be justified by its annual earnings. If it is found that the actual capital employed is more than what is justified by its earnings, the firm is said to be over-capitalised and if, on the other hand, it is less than the amount as justified by its earnings it is treated as a case of under-capitalisation. Another measure of assessing whether a firm is over-capitalised or under-capitalised lies in comparing the actual rate of return on capital employed with the normal rate of return based on industry's average earnings.
- The financial requirement of a firm can be met through ownership capital (equity)

Notes

and/or borrowed capital (debt). The firms normally use a judicious mix of debt and equity in order to ensure a higher return on owners' funds. Such a mix is termed as the 'Capital structure' of the firm. The choice of an appropriate capital structure is determined by a host of factors. They are: (1) expected earnings and their stability, (2) cost of debt, (3) effect on right to control, (4) capital market, (5) regulatory norms, (6) flexibility, and (7) investors' attitude towards investment.

- Dividend refers to the amount of profits distributed by a company to its shareholders. The amount of profit to be distributed as dividend and the amount of profit to be retained by the company for meeting its future financial requirement is determined by factors like future financial needs of the company, liquidity requirement, company's access to capital market, expectations of the shareholders, tax policy, investment opportunity and growth prospects and legal constraints, if any.

## 17.7 KEY TERMS

| | | |
|---|---|---|
| Capital structure | Capitalisation | Dividend |
| Financial mix | Fixed capital | Over-capitalisation |
| Retained earning | Trading on equity | Under-capitalisation |
| Working capital | Working capital cycle | |

## 17.8 TERMINAL QUESTIONS

**Very Short Answer Type Questions**

1. What is meant by over-capitalisation?
2. Define the term 'Dividend'.
3. What is meant by 'Optimal Capital Structure'?
4. State any two effects of over-capitalisation.
5. Mention any two remedies of under-capitalisation.

**Short Answer Type Questions**

6. State any four objectives of financial planning.
7. Explain any two factors that are taken into consideration while determining the fixed capital requirement of a company.
8. Do you advocate distribution of whole amount of profits earned by a company as dividends? Support your view with reasons.
9. Describe any two determinants of capital structure.
10. What is meant by 'Trading on Equity'?

**Long Answer Type Questions**

11. What is meant by 'Financial Planning' ? Explain any four requisites of a sound financial plan.
12. How do you ascertain that a firm is over-capitalised? Explain with an example and state the main causes of over-capitalisation.
13. How does raising of long term funds through debt affect the return on shareholders' funds? Explain with an example.
14. What is meant by 'dividend'? State the factors that affect dividend decision.
15. How do you assess the amount of working capital required by a business unit? Describe in brief.

## 17.9 Answers to Intext Questions

| | | | |
|---|---|---|---|
| **17A** | 2. | (c) | and (e) |
| | 3. | (a) | Yes |
| | | (b) | No |
| | | (c) | Yes |
| | | (d) | No |
| | | (e) | Yes |
| **17B** | 2. | (a) | More |
| | | (b) | Less |
| | | (c) | More |
| | | (d) | Less |
| | | (e) | More |
| | 3. | (a) | (iii) |
| | | (b) | (iv) |
| | | (c) | (vi) |
| | | (d) | (v) |
| | | (e) | (i) |
| | | (f) | (ii) |
| **17C** | 2. | (a) | Correct |
| | | (b) | Correct |
| | | (c) | In-correct (Under-capitalisation refers to a situation when the actual rate of earnings is more than the normal rate of return). |

(d) Correct

(e) In-correct (Over-capitalisation is more harmful than under-capitalisation).

3. (a) 18000 X 100 / 15 = Rs.1,20,000

(b) Over capitalised as its actual capital employed is Rs.1,50,000 which is more than the proper (fair) capitalisation (Rs.1,20,000) and that the actual rate of earnings is 12% as against the normal rate of earnings which is 15%.

**17D** 2. (a) Yes

(b) No – It involves minimum risk of dilution in control by existing shareholders.

(c) No – It caters to all types of investors

(d) No – It ensures maximum return on equity

(e) Yes

(f) No – It has the necessary flexibility to make required reduction or addition to funds, according to changed conditions.

**17E** 1. (a) Profit After Tax

(b) Profits Before Tax

(c) Profit Before Interest and Tax

2. (a) Financial needs of the company

(b) Liquidity

(c) Access to capital market

(d) Tax policy

(e) Legal constraints

3. (a) Amount of profit distributed to shareholders.

(b) The part of profit retained in the company to meet the company's future financial needs.

(c) Dividend paid to preference shareholders.

(d) Dividend paid to equity shareholders.

## DO AND LEARN

Pick up any 10 items/products that you see/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?

Notes

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

## ROLE PLAY

Mr. K. Gandhi was the director of Alter Ltd. He was very upset when the finance manager Mr. R. Khanna presented the financial report of the company before him.

Mr. Gandhi : What is this Mr. Khanna?

Mr. Khanna : Sir, to be honest, this is the real position of the firm. Our firm as of today is over-capitalised.

Mr. Gandhi : When we started this company four years back it was having normal/proper capitalisation.

Mr. Khanna : May be sir, but it is not so now?

Mr. Gandhi : What makes you say that?

Mr. Khanna : Sir, in the first place our returns on investment is not justified.

Mr. Gandhi : What do you mean by that?

Mr. Khanna : Sir, the other firms in the industry are earning average return of 10% and ours is only 8%.

Mr. Gandhi : What else?

Mr. Khanna and Mr. Gandhi discussed the causes, effects and remedies of over-capitalisation.

You are required to continue the above conversation by assuming a role for yourself and one for your friend.

## Chapter at a Glance

17.1 Financial planning
- 17.1.1 Objectives of financial planning
- 17.1.2 Essentials of sound financial plan

17.2 Types of capital requirement
- 17.2.1 Fixed capital
- 17.2.2 Factors determining fixed capital requirement
- 17.2.3 Working capital
- 17.2.4 Factors determining working capital requirement

17.3 Capitalisation
- 17.3.1 Over-capitalisation
- 17.3.2 Under-capitalisation

17.4 Capital structure
- 17.4.1 Factors determining the capital structure

17.5 Dividend
- 17.5.1 Factors affecting dividend decisions