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BUSINESS FINANCE

IMPORTANCE

Financial planning is an important part of overall planning of any business enterprise. It aims at enabling the company to tackle the uncertainty in respect of the availability and timing of the funds and helps in smooth functioning of an organisation. The importance of financial planning can be explained as follows:

(i) It tries to forecast what may happen in future under different business situations. By doing so, it helps the firms to face the eventual situation in a better way. In other words, it makes the firm better prepared to face the future. For example, a growth of 20% in sales is predicted. However, it may happen that the growth rate eventually turns out to be 10% or 30%. Many items of expenses shall be different in these three situations. By preparing a blueprint of these three situations the management may decide what must be done in each of these situations. This preparation of alternative financial plans to meet different situations is clearly of immense help in running the business smoothly.

(ii) It helps in avoiding business shocks and surprises and helps the company in preparing for the future.

(iii) If helps in co-ordinating various business functions e.g., sales and production functions, by providing clear policies and procedures.

(iv) Detailed plans of action prepared under financial planning reduce waste, duplication of efforts, and gaps in planning.

(v) It tries to link the present with the future.

(vi) It provides a link between investment and financing decisions on a continuous basis.

(vii) By spelling out detailed objectives for various business segments, it makes the evaluation of actual performance easier.

CAPITAL STRUCTURE

One of the important decisions under financial management relates to the financing pattern or the proportion of the use of different sources in raising funds. On the basis of ownership, the sources of business finance can be broadly classified into two categories viz., ‘owners funds’ and ‘borrowed funds’. Owner’s funds consist of equity share capital, preference share capital and reserves and surpluses or retained earnings. Borrowed funds can be in the form of loans, debentures, public deposits etc. These may be borrowed from banks, other financial institutions, debentureholders and public. Capital structure refers to the mix between owners and borrowed funds. These shall be referred as equity and debt in the subsequent text. It can be calculated as debt-equity ratio

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i.e., $\left(\frac{\text{Debt}}{\text{Equity}}\right)$ or as the proportion of debt out of total capital i.e., $\left(\frac{\text{Debt}}{\text{Debt} + \text{Equity}}\right)$.

Debt and equity differ significantly in their cost and riskiness for the firm. Cost of debt is lower than cost of equity for a firm because lender’s risk is lower than equity shareholder’s risk, since lenders earn on assured return and repayment of capital and, therefore, they should require a lower rate of return. Additionally, interest paid on debt is a deductible expense for computation of tax liability whereas dividends are paid out of after-tax profits. Increased use of debt, therefore, is likely to lower the overall cost of capital of the firm provided that cost of equity remains unaffected. Impact of a change in the debt-equity ratio upon the earning per share is dealt with in greater details later in this chapter. Debt is cheaper but is more risky for a business because payment of interest and the return of principal is obligatory for the business. Any default in meeting these commitments may force the business to go into liquidation. There is no such compulsion in case of equity, which is therefore, considered riskless for the business. Higher use of debt increases the fixed financial charges of a business. As a result, increased use of debt increases the financial risk of a business. Financial risk is the chance that a firm would fail to meet its payment obligations. Capital structure of a business thus, affects both the profitability and the financial risk. A capital structure will be said to be optimal when the proportion of debt and equity is such that it results in an increase in the value of the equity share. In other words, all decisions relating to capital structure should emphasis on increasing the shareholders wealth.