Basics of Finance

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Financial Plan details the

- Complete picture of how much and when funds are coming & going from the company?
- What is the projected financial position of the firm?
- How much cash is available?
- It provides the short term basis for budgeting control and helps to prevent one of the commonest problems of a new venture – Cash Crunch

Value to the Investor

- Explains how the entrepreneur plans to meet all financial obligations and maintain liquidity in order to either pay off the debtor or provide a good Return on Investment

- 3 years of projected financial data and monthly data of flows for the first year is an ideal recommendation for your financial planning

Financial Planning – its functions

- Estimate financial requirements for future
- Identify sources
- Arrange for the finance
- Proper allocation & control

TO PONDER

- Internal financing OR External financing ?

1. Should the business have 'borrowed' capital? If so, how much?
2. What is the correct mix of 'Long term' and 'Short term' funds?

How Much Money Do We Need?

- Capital Expenses (Capex) – Capital Budgeting
  - Money for capital investment
    - Examples: Equipment, Building

- Operating Expenses (Opex) – Working Capital
  - Permanent Working Capital for operating the business
    - Level of permanent WC grows as business grows
  - Temporary Working Capital
    - To meet seasonal or peak periods

Capital Budgeting

- Money for investment in Fixed assets/Capacity/ infrastructure the benefits of which are received over period of time
- They are generally:
  - Irreversible
  - Non-flexible
  - Expensive
  - Affect profitability of the concern
- Methods used to evaluate proposals:
  - Pay back period
  - NPV

Working Capital Management

- Working Capital (WC) is so called because it is required to make the fixed assets work
- The amount of WC is determined by:
  - the nature of the business, size of the fixed assets,
  - the complexity of the production process
- WC should be adequate (neither too much nor too little) to meet day-to-day operational needs of the business

Working Capital

- What does working capital mean?

Working capital = Current Assets – Current Liabilities

- What does + ve or – ve working capital indicate ?
- How much working capital is adequate for a business ?

Some important indicators of Working capit

- Working capital turnover:

  Sales / Working capital

- Current Ratio

  Current Assets / Current Liabilities

- Days Sales outstanding

  Receivables/ Annual Sales/ 365 days

- Inventory Turnover Ratio

  Cost of Goods sold/ Inventory

Important issues to consider

	Equity	Debt
Cash Flow	Dividend	Interest, Principal Repayment , Tax Shield
Collateral	Not required	Required – assets are collaterized
Ownership	Dilution Loss of control	Not affected

Types of Finance: Equity

- Inside equity:
  - founders, friends, family
- Angel Investors
- Venture Capital
- Public Offering:
  - The ultimate in wealth creation

  - DEBT- BORROWINGS

ACCOUNTS

- Accounting is the art of recording, classifying and summarising the transactions of financial nature and interpreting the results to know about the health of the organisation

Major Financial Statements

- Profit & loss A/C
- Balance Sheet
- Statement of Cash flows
- Statement to stock holder's equity
- Notes to Accounts

Financial Statements

Financial Statements consist of:

- the **Balance Sheet** which is a snap shot of the financial position of the business as on a particular date
- the **Income Statement** (Profit & Loss Account) which shows the results of the operations during a period
- the **Cash Flow Statement** which shows the receipts and payments of cash/money during a period

Format of Income Statement

Income statement for the year ending ………

A. Income

Sale of goods / services
Financial income
    Interest / Dividend received
    Profit on sale of Investment
Misc. receipts (scrap sales etc)

B. Expenditure

Cost of goods sold
Employee expenses
Bought-out services
Depreciation
Operating expenses
Financial expenses (eg: Int paid)
Provision for expenses/losses
(eg: Bad Debts, Obsolete goods)
Amortization of expenses

C. Profit Before Tax (PBT) (A – B)

Less :Tax provision

=

D. Profit After Tax (PAT)

Less: Transfer to Reserves

=

E. Profit for Distribution

Cash Flow Statement

- A cash flow statement shows the sources and uses of cash in the business:
  - operating activities
  - financing activities
  - investing activities

The acid test of any business is its ability to pay the financial obligations (eg: employees salary, supplier payments, loan repayment etc) as and when they fall due

Cash Flow Management

- What is Cash Flow ?
- What are Sources and Uses of Cash in a business ?
- How important is Cash Flow Management in a business ?
- Relationship between Profit/Loss and Cash Flow

What is cash operating cycle?

- Time taken for cash to be converted to raw materials to be converted into finished goods which needs to be converted to debtors which then converts to cash

To calculate OCC

A. Debtors velocity in days

Debtors /daily credit sales

B. Stock velocity in days

stock / cost of goods sold x365

Adding A & B we get gross OCC

Deducting the creditors velocity we get Net OCC

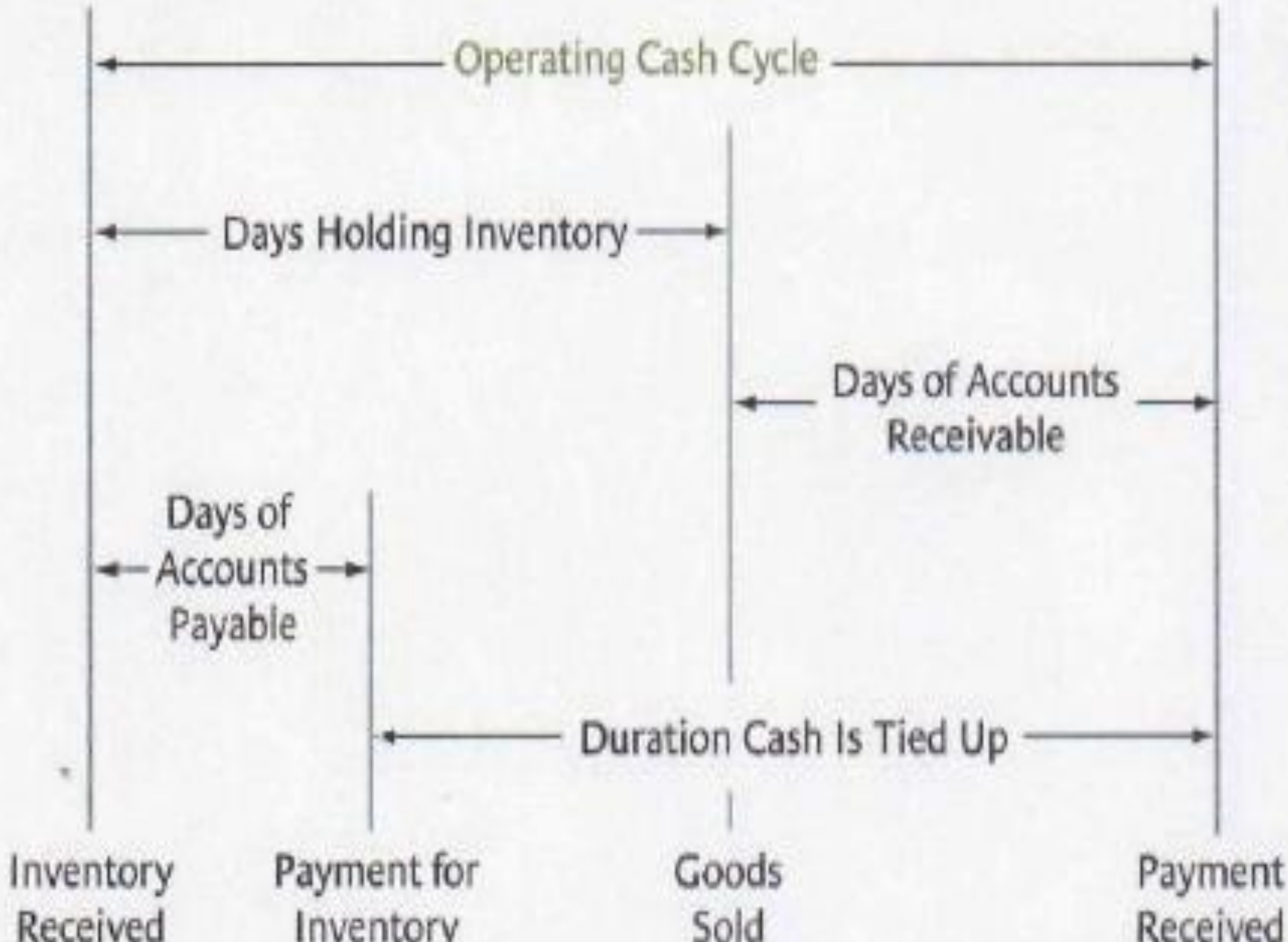
What are cash days?

Calculating the number of days it takes to collect the debtors or completely finish the stock

How to calculate Debtors cash days?

- Credit period given to debtors as per policy
- Changes by way of discounts can hasten collections and bring down sales but save money on investment returns.

Components of an Operating Cash Cycle



Profit is an ***opinion***, but cash is a ***fact***”

- Mr. Narayanamurthy (Infosys)

Key financial parameters to track

- Concept of unit pricing and Break even point
- Fixed cost and recurring costs
- Marginal contribution and profits
- Cost of own capital and borrowed capital
- Cash flow and PnL
- Working Capital Management

Costs – Volume – Profit Analys

- Fixed Costs and Variable Costs
- Costs are predictable over entire range of volume
- Constancy of unit selling price
- Stability of product mix
- Volume of sale = volume of production during an accounting period (inventory changes are nil)

Break-even Point

- Sales at which total revenue earned equals total costs incurred (TR=TC).
- TR = Selling Price x Quantity
- TC = Fixed Cost + (Variable Cost/unit x Quantity)
- Q = F/P – V
- Q = Profit + Fixed Cost /Marginal Contr
- Breakeven Sales in Rs =

  Fixed cost/(1-(V/P))

Break Even Analysis

- Margin of Safety
- What is the importance of BeP in business?
- What are the shortcomings of BeP
  - In a complex cost structure not all costs can be classified as direct and indirect
  - Ignores time value of money
  - Non linear relation between P and V

Ratios

- **Liquidity Ratios - Short term solvency**

  - Current Ratio - Current assets/ Current Liabilities

  - Acid Test Ratio (Quick Ratio) =

  (Current assets-Inventories)/Current Liabilities

  - Average Collection Period =

  Average Receivables/ Average per day sales

  - Inventory Holding Period =

  Average Inventory/Av. COS per day

Investor seeks

- The longer you wait (and the more developed the opportunity), the less the cost to you (less risk to the investor).
- Seek money BEFORE you need it.
- Investors will probably give their money in stages, providing you hit certain targets.
- Investors may ask for seats on the board of directors, and other controls before investing.

Sensitivity to Risk: Fixed Cost vs. Variable Cost

- Reduce Fixed Cost component as much as possible!
- Look into every expense and be sure of the NEED for Fixed Cost
  - i.e. Is there a Variable Cost option?
    - Capex – e.g. Buy or lease machinery, office space
    - Opex – e.g. Salary – Permanent vs. temporary contract

Sources of Debt Fund

InstitutionaL	Non-Institutional
24%	76%

Key Source of Funding for Social
Sources of Debt Fund
Enterprises

22% - Total Grants
22%- Equity
56%-Debt

Source: *Beyond Profit, Social Enterprise Landscape Survey, 2010.*

POLICY TRENDS

The National Innovation Council, set up by the Prime Minister in 2010 to catalyze innovation in India, is considering establishment of a government-backed venture capital fund.
The size of this fund will be in the ballpark of $200 million.The primary focus of this fund would be to address developmental needs in education, health, infrastructure, and sanitation.
Floated a policy paper suggesting the need to separately recognize and regulate “Social Venture Funds”. It outlined that these funds are for investors seeking “muted”returns in their investments in return for social gains