

De-CODING Financial Jargons

FOR EASING YOUR SWAVALAMBAN JOURNEY

SWAVALAMBAN INFO SERIES – VOLUME 9

"I measure the progress of a republic by the degree of progress which women have achieved".

- Dr. Ambedkar

"Take up one idea. Make that one idea your life - think of it, dream of it, live on that idea. Let the brain, muscles, nerves, every part of your body, be full of that idea, and just leave every other idea alone. This is the way to success."

- Swami Vivekananda

Message



SIDBI, under its vision 2.0, has been consistently pursuing innovative, inclusive and impact-oriented engagements. Resolving the challenges of information asymmetry has been one of our avowed resolve for livelihood and micro enterprise promotion. This ninth issue of information series brought out by SIDBI endeavours to resolve the challenges of many entrepreneurs (swavalambis), who are so good with their business, but somehow struggle with the financial jargons. What's a balance sheet? What on earth is a DSCR? How do I remain updated on bankability aspects? Would I be able to convince lender from financial angle? That's what is different with this edition. It de-complicates these jargons in a very simple language. It's the language that you and we use.

I am pleased to know that, while this edition is targeted at all aspirants, but is particularly dedicated to Women who are the ambassadors of our avowed mission Swavalamban- Each House, One Entrepreneur (Har Ghar Ek Swavalambi). We at SIDBI firmly believe that Women are the most important pillar for inducing entrepreneurship culture within family & society, particularly next gen.

V Satya Venkata Rao
DMD SIDBI.

Preface

Swavalamban Greetings!

Yes, we know you have been enjoying reading the earlier eight issues where we attempted what, where, whom and when of this ecstatic entrepreneurial journey. By taking a call to walk this journey, you have given wings to dreams of crores of aspirants towards the national mission of Aatmanirbhar Bharat.

Congrats that you have decided to write your swavalamban (enterprising) dreams on white slate.

Some of entrepreneurs shared that one of the factors troubling them in this unique & colourful journey has been the equations, formulae and seemingly complex jargons used by lenders and financiers. Entrepreneurs are keen to unravel the mystery of some of these ticklish words as also maintain bankability.

Our team thought that why not to slice these heavy fruits in palatable or digestible form and serve them on platter with simpler words. The integral fin-mantras have to be deciphered and be understood well. Here we are with the next version of your info series which endeavours to be your trusted friend.

While dedicating this edition to enterprising women, we salute with pride the daring 10000 rural women of our Mahila Sashaktikaran Programme who celebrated being entrepreneurs. Also hats off to 1700 homepreneurs of Swavalamban Silai school who smilingly withstood challenges and stood their ground even amidst the Covid-19 pandemic. We bow down to 47 unknown rural women who while hesitantly onboarded digital market platform, gave tough talk to established entrepreneurs by quickly picking the nuances of growth rope and enthralling consumers with quality and customized product offerings.

Our edition salutes the guts of SHEs (Sanitation and Hygiene Entrepreneurs) initiative. The pilot which started from one state has within nine months spread to 21 states. They are enterprising covid heroes. The present edition draws inspiration from partner institutions, Women Bank Sakhis / SHGs from Impact projects supported by us under the Poorest States Inclusive Growth Programme and Swavalamban Resource Facility (in partnership with DFID UK (now FCDO). Many of these are today poised to evolve and establish as Livelihood Promotion Hubs and set high benchmarks for women centric enterprise promotion.

It's an army band salute to all women who dared to dream beyond boundaries and decided to take brisk walk amidst risk talk. By taking plunge in the unknown, uncharted territory & segments they have expressed resolve to be inspirational to aspirational India.

Our thumbs up to near one lakh women entrepreneurs of Stand-Up India who started greenfield enterprises and are emerging as national role models.

Our resolve to strengthen eco system is becoming stronger day by day. When enterprising youths smile it makes us take leap for those sprint miles which are tough but inherently soothing

Seeds have been sown, green shoots are emerging, & flowers shall bloom. We are there with you all, not ahead or behind but right by your side. Let's weave lively Atmanirbhar Bharat, together.

Happy Reading!
Team SIDBI - MIssion Swavalamban

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Why to borrow- when does need arise, why to go for term loans

If you plan to take a debt, it is possible that you may get a lot of naysayers claiming, '**No debt is a good bet'**. You may be flooded with lots of cautionary tales which may conclude that taking debt is extremely risky.

While it's true that you should not take debt for every other reason without analyzing the costs and benefits associated with it, there are a lot of good reasons when you should certainly plan to get one.

Reason #1: You are planning to start a new business

When you have a good business idea which you zeroed in after looking at the market, your core competence and are convinced about its profitability, you would need capital to start. This capital may not be available with you immediately, and bank finance can be a life saver.

However, it is important to look at your profit projections and analyze whether the future cash flows will be more than the cost of servicing your debt. If the answer is yes, you are good to go.

Reason #2: You need to expand your business

You may be getting a lot of business and your office may be getting smaller to service all of it. Or you may be requested by your customers to start your services in another location considering the huge demand for your products/service. It's a great news that your business is booming, but that does not mean that you may be having the funds to expand as it is a huge investment.

In such a scenario, it is a good idea to look for bank finance after you make an analysis that the profits generated by the expansion shall be enough to cover cost of the finance.

Reason #3: You need new equipments

You may be requiring equipments to fulfil your orders, or there may be some technologically advanced equipments which would save time and labour costs while increasing your profits. In such scenarios, it is a great idea to finance your equipment though bank loan. Another good thing with equipment financing is that often the existing equipments also come handy as collateral for your loan. Loan can be availed in several forms, the most common of them being term loan and working capital. More on that in the coming chapters.

However, it should be taken into consideration that the equipments add value to your business and are not just for aesthetic or luxury purposes.

Reason #4: You may need to expand your inventory

To ensure that your sales are serviced on time, you may need to keep your inventory replenished at all times. During such times inventory finance comes to your rescue. At times when you have to acquire inventory in advance, like in the times of an upcoming seasonal demand so that you are ready with servicing your orders when the season starts. At such time, it is a good idea to compare the cost of your debt to the projected sales of your products to determine whether to go ahead with the loan.

Reason #5: There is a good business opportunity that outweighs the potential cost of your debt

Suppose you get new order for ₹10,00,000 for which you would need to purchase an advanced machinery costing ₹2,00,000. However, you have owned fund of ₹50,000 but don't have additional funds to purchase that machinery. Now, considering you take an equipment loan of ₹1,50,000 for two years with an interest rate of say 10% p.a. which may work out to yearly interest cost of ₹ 15,000, the total cost of your investment shall be 2,00,000 + 2*15,000 = ₹ 2,30,000. If we account for inventory cost & other utility cost (power, fuel etc.) for servicing the order at 65% of order value, which may work out to ₹6,50,000, you may still end up with a profit of ₹1,20,000 (10,00,000 – 8,80,000). Which means, it is a good investment even after factoring in the cost of credit & the cost of production.

Reason #6: Requirement side - You may need to maintain your working capital

Working capital is the capital you need for you day to day operations. We shall learn more about it later, but for now let's understand this scenario.

When you start a new business, it may happen that your customers may their payments later, but your suppliers have to be paid on time. This may lead to cash crunch which may exacerbate when your orders increase. To prevent such situation, you can go for a working capital loan so that your day to day operations don't' stop.

Reason #7: Means of finance side - It may be costlier to use your equity for financing.

While this idea of using loan despite having your own funds may be counterintuitive, the rationale is that by spending equity, you are sacrificing your future profits forever. However, debt, though a liability today, will not remain forever and you can pay it back. You can still have your equity available for your business exigences.

Reason #8: Debt eases your tax burden

With debt, your taxable income gets reduced and hence your profits will attract lower tax. This should factor in while comparing the overall cost of debt with the returns generated by that debt.

Reason #9: You need to employ skilled employees

While in the beginning of your business, you may be performing a lot of its activities on your own, as your business expands you may need more skilled and helping hands to

ensure quick delivery of quality products. This investment in fresh talent may require additional funding.

Reason #10: You need to build your credit profile

When you suddenly request a bank for a huge loan with no previous credit history, it will be difficult for the bank to assess your credit eligibility. So, it's a good idea to take small loans initially for your smaller business requirements and with credit discipline, build a good credit history. This will help you in cases when you think of expansion and need a substantial loan amount. Here, it is important to mention that even your credit card transactions and payments affect your credit score. Hence, you should make it a point to ensure timely payment of your credit card dues.

Generally, banks go for a credit score of 700 and above. So, it is advisable to maintain a good score through timely repayments of your small loans before you go for a big one.

What is a Term Loan.?

A term loan is a loan for a specific amount with a pre-specified repayment schedule and either a fixed or floating interest rate.

But what is fixed and floating interest rate?

Fixed interest rate is one which does not change during the tenor of the loan.
Floating interest rate is made of two parts – a) index and b) spread. Banks will link the interest rate to some index, for e.g.- their MCLR (Marginal Cost of Lending rate) which changes with the changes in the market and then will add a spread to it, which will depend on the credit risk your loan carries.

Which one is better for me?

To answer this question, you can look at your investments. The investment options like FDs, RDs are safer as they have a fixed return while instruments like Systematic Investment Plans (SIPs), mutual funds, stock market investments are riskier since their returns depend on the market. However, latter generally provide more higher returns than the former.

The same is the case with fixed and floating interest rate. While fixed interest rate offers you the cushion of predictability and low risk, floating interest rate, though riskier, can give the benefit of low interest rates in case of favorable market scenarios.

Generally, floating rates are lower than fixed rate to begin with and can be a good option especially if your loan is of a short duration. This is because even if later the rates increase, there is a good option that you will be paying lower rate for most part of your loan cycle.

On the other hand, if you want to have your peace of mind by taking a fixed rate of interest, it is crucial that you discuss all terms with your lender. This is because at times there is a clause in the loan terms which states that the rate can be increased at some point. In such scenarios, you may be under the illusion that your rate is fixed while it may not be.

There are also combination interest rates which is part fixed and part floating. This is also a good option if you can estimate when you will break even.

It is a good practice to keep an eye on the market scenarios whether you have taken a fixed or floating rate of interest. Depending upon the situation, you can switch from fixed to floating or vice versa after paying a fee. This fee is not a bad bet especially if you have a large loan.

Why should I go for a term loan?

Term loan is the credit given by banks in a fixed amount and for a pre-decided repayment period at a fixed or floating rate of interest. Generally, when you need to acquire fixed assets like plant and machinery, you go for term loan. So, when you are certain that the returns from your long-term investments will be able to pay the loan amount, you should finance these investments with a term loan.

A term loan is often appropriate for an established small business with sound financial statements. Also, a term loan may require a contribution from your side, called promotor's contribution as a percentage of your project cost.

Looking at an example, suppose Fresh Foods is a cold storage company. It needs to purchase a new factory building and refrigerators which have a total cost of ₹10,00,000. For this investment, its bank sanctions a term loan of ₹8,00,000 and ₹2,00,000 is to be the promotor's contribution, also called margin money. Interest charged on the loan is a floating rate of MCLR + 1 % and the loan tenure is 5 years including a moratorium of 1 year. During the period of moratorium, Fresh foods needs to pay only the interest. Repayment

shall start from the second year with a fixed monthly installment of ₹15,000 for 47 months followed by last installment of ₹95,000.

In contrast, a working capital limit, which is discussed in detail in the next chapter, is used to fund your short-term requirements of day to day operational expenses like raw material purchase, staff salaries, factory rent, etc. There is no fixed instalment unlike term loan and no moratorium. Instead, you get a credit limit based on your creditworthiness. You can borrow any number of times up to your credit limit. Interest is levied only on the amount withdrawn and the limit tenure is maximum of one year after which it needs to be renewed.

Key Takeaways:

- *Contrary to the general belief, debt, when taken calculatedly, is good for your business. You have check and balance and freely available monitoring from banks who shall alert you on getting drifted*
- *For taking new loan, it's a good practice to first compare the projected cash flows from your investments to the cost of loan.*
- *Business loan can help in multiplying your profit, improve your credit score, ease your tax burden, cushion your working capital.*
- *Companies often use a term loan's proceeds to purchase fixed assets, such as equipment or a new building for its production process.*



Breaking the mystery- Working capital

Working capital can be defined in layman's terms as

The Capital that ensures that your business keeps working.

Let's talk about capital first.

When we have to do a business, naturally we would need to make investments like purchasing of factory building, machinery, equipments, etc. We would also need cash in the business to fund our day to day expense. These investments for the capital for our business.

Then what exactly is Working Capital?

Working capital is that part of capital through which you fund the day-to-day operations of your business, pay rent and staff, and cover other operating expenses.

Working Capital Gap = Current Assets – Current Liabilities

To understand this formula, we need to understand what is meant by current assets and current liabilities. But before that, let's go to a more basic level and understand assets and liabilities.

Every business runs by assets that you own which are funded by liabilities which you owe.

Similarity, liabilities are paid off by your assets.

Assets: Anything which is owned by your business is an asset for your business. For example- cash, receivable bills, factory building, machinery, equipments, furniture, etc. They are assets for you as they generate income in the form of cash/cash equivalents to you as a result of business operations at some point of time.

In addition to physical or tangible goods which can be touched and seen, assets can also be in intangible form like trademarks, patents, copyrights, goodwill, brand name etc. Though they can not be seen or touched in physical sense, they provide long term value to the company.

Intangible assets can be definite or indefinite. For example, patent is definite as it will expire after the patent is over, however, a brand name is indefinite since it will continue through the company's existence.

Liabilities: Anything which your business **owes** is a liability to your business. For example- bank loan, lease rentals, staff salaries, utility bills, etc. These are liabilities for you as they have to be paid at some point in time.

Now talking about current assets and current liabilities.

Current assets, as the name suggests, are those assets which are 'current' in nature, i.e.- of short term and shall generate cash or cash equivalents (like commercial paper, T-Bills, etc.) within a year. In simple terms, the business shall use these assets and earn cash/cash equivalents within a period of one year. Examples of current assets are cash, cash equivalents, accounts receivables, etc.

Current Liabilities, similarly, are the liabilities which need to be re-paid within a year. When running a business, you will need to purchase raw material, pay staff salaries, rent etc. These have to be paid in a year and hence called current liabilities.

Current liabilities are paid by your current assets and the gap of these two is your net working capital. In other words, working capital is what shall remain if you have to pay off all your current liabilities with all your current assets. This surplus is necessary to pay for the daily operational expenses of your business and its shortage shall imply that your business may come to a halt.

Your net working capital tells you whether you have enough resources to fund your day-to-day operations in case you have to sell off all your current assets to pay all your current liabilities.

Let's look at the example of a cybercafé:

Current Assets:
(Rs. 5,00,000)



Inventory



Cash

Current Liabilities:
(Rs. 1,50,000)



Wages



Rent



Utilities

The café has a working capital of ₹3,50,000 (₹ 5,00,000 –₹1,50,000) which means that if *it has to pay all its current liabilities of ₹1,50,000 at once using its current assets of ₹5,00,000,* it can comfortably do so and shall still be left with an excess of ₹3,50,000 which it can use for its operational expenses.

The café thus has comfortable level of working capital.

How is working capital different from my Fixed Capital?

Fixed capital is the amount you invest in your business for acquiring fixed assets like land, building etc. for the company. These assets generate economic value gradually and have lower liquidity, i.e.- if need may arise, they are difficult to be converted to cash immediately by selling.

On the other hand, working capital is the amount you invest in running the day to day operations of your business, like raw material purchase, payment of salaries / rentals etc.

So, I understood the concept. But how do I know whether my business possesses enough Working Capital so that my business doesn't come to a standstill?

To know the amount of WC possessed by your business we look at the Working capital Gap which we have already discussed. But for analysing whether this working capital is too little or too less, we need to use the following formulas:

Current Ratio

With Current Ratio, you can identify the ability of your business to fund its short-term obligations with only the current assets.

Current Ratio = "Current assets/Current liabilities"

The ratio is interpreted as:

- A value <1 means your current liabilities are more than your current assets which can be indicative of potential liquidity problems in the business.
- >2 suggests that current assets are more than current liabilities however, it may also mean that the business has a lot of unutilized working capital assets which it could invest to generate maximum possible revenue and has too much cash tied up in inventory or debtors.
- You may aim to maintain a ratio between 1.5-2.
- **A declining ratio over the long term could be a red flag and requires immediate attention**. For example, it could indicate slow collection of receivables.

Quick Ratio or Cash Ratio

With quick ratio, you can identify your business' ability to fund its short-term obligations with only the liquid current assets. In other words, it tells you the fastest you can pay off your current liabilities, if the need may arise.

It uses those current assets in the numerator which can be immediately converted into cash.

Quick Ratio = (Cash and marketable securities and accounts receivable)/Current Liabilities.

It is also called Acid Test or Liquidity Ratio.

**Liquidity is the measure of how fast an asset is converted to cash. The more liquid an asset is, the more quickly it can be turned into cash. The most liquid asset is understandably cash itself.*

Working Capital Turnover Ratio

Working capital is a resource to the business and every resource has the potential of generating revenues or sales. With WCTR, you can assess how efficiently your business can convert its working capital to sales.

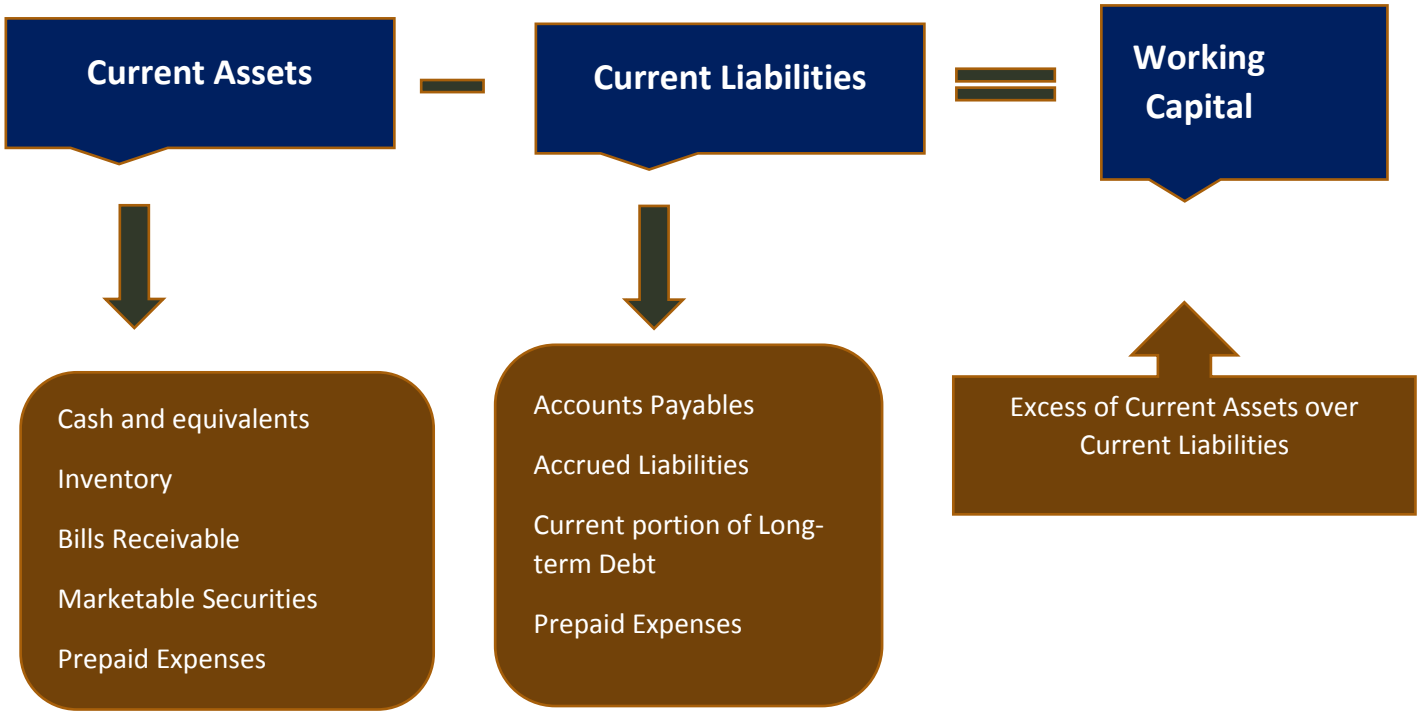
WCTR = Net annual sales/working capital

More WCTR means higher efficiency.

Take a look at the annual sales of a cybercafé which is ₹ 10,00,000 and the working capital ₹1,00,000. The WC of Rs. ₹1,00,000 is a resource for the café which should be utilized in generating sales for the business. The WCTR shall be

10,00,000/1,00,000 = 10, which implies that the café spent its WC of Rs. 1,00,000 ***ten times*** *to generate the sales of ₹10,00,000.*
In the same case, if working capital is ₹50,000, then the WCTR shall be 20, which is twice of that in the first case. Now even though same sales is being generated in both cases, since

less WC is used for generating the same sales, ***it means the money is made to work harder for the café and hence, is being utilized more efficiently.***



Key Takeaways:

- *The gap between your current assets and current liabilities is your working capital.*
- *Working capital indicates the amount of resources available for running the day to day operations of the business.*
- *Negative working capital shall mean liquidity crunch which may lead the business to a standstill.*
- *Current ratio measures whether you have enough current assets to pay off your current liabilities.*
- *Quick ratio or Acid test Ratio looks at the most liquid current assets to pay off your current liabilities.*
- *WCTR calculates the efficiency of your business in converting your working capital to sales.*
- *We need to monitor working capital and if any discrepancies are found, immediate steps must be taken.*
- *A Good working capital ratio will increase the overall financial health and guarantees liquidity*



Credit Rating

Suppose two people go a small finance bank for their business loans. Both have same requirements, need same amount of loan and are planning to buy similar machines. The bank finds both of them to be suitable for the loan yet offers them different rates of interest. How does the bank decide this? The answer is credit rating.

Credit rating is the rating calculated by a financial institution based on the creditworthiness of a business.

How does a bank decide my creditworthiness?

Creditworthiness is based on several parameters like-

- Resourcefulness of the borrower for example - whether borrower has sufficient working capital to fund the business operations.

- Promoter's contribution being offered by the borrower – more contribution shall mean lesser risk to the banker.
- Security being offered for the loan (explained in later chapters),
- External Credit score

Higher creditworthiness translates into better credit terms and vice versa though low creditworthiness may even mean refusal by the bank to grant loan. Banks use their own internal mechanism to generate rating for an entity while there are also designated credit rating agencies to provide external credit rating.

Indian credit rating industry mainly comprises of **CRISIL, ICRA, CARE, ONICRA, FITCH & Acuite**. CRISIL is the largest credit rating agency in India. Generally, any financing institution shall look at both internal as well as external credit rating to decide the creditworthiness of a borrower.

Credit report can be obtained for free at several websites.

How do I ensure I have a good credit rating?

Whenever you approach a bank for a loan, the first thing it will look into is your capability to repay that money. The most critical element to estimate this is your payment track record. If you have made all your previous loan payments on time, and have not lapsed on your payments, this shall reflect positively on your credit score and will make you a good candidate for the loan.

Since the perception of risk varies with the creditors, each bank will have a different approach when looking at your creditworthiness. Every bank maintains an internal credit rating mechanism the components of which vary from bank to bank. However, the basic requirements of all the banks are similar and good credit rating can be achieved by following good management, financial, industrial practices.

Do's and Don'ts to ensure creditworthiness.

Do's

- Have a sound business plan.

- Ensure skilled and knowledgeable staff.
- Maintain the quality of your product.
- Develop a good business network.
- Maintain a healthy cash flow.
- Pay your statutory dues on time.
- Regularly check your credit score and take corrective measures if it is lowered.

Don'ts

- High leverage or taking too many short-term loans.
- Delays in the payment of your existing loans and credit card payments.
- Late filings of ITRs Or other returns.
- Improper maintenance of financial statements.

For more inputs on the matter, you can download our bankability kit from:

https://udyamimitra.in/uploads/gallery/media/MSEbankabilitykit2.pdf

Key Takeaways:

- *Any creditor will assess your creditworthiness to determining your eligibility in getting credit.*
- *The more creditworthy you are, the better your terms of credit will be.*
- *Borrower can ensure good credit rating through maintaining low leverage, timely payment of dues, maintaining sound financial parameters of the business, etc.*
- *Discuss with your borrower in the event of low creditworthiness on the parameters you need to improve so as to improve your credit prospect in the future.*



Myths – primary and Collateral, collateral free, reputational collateral?

As discussed earlier, the prime importance for a creditor is that the borrower repays the money lent to him. But how does the bank ensure that the money is returned?

The answer is security.

Loan security is an asset(s) which is taken by the creditor in lieu of the loan so that if the borrower fails to make loan payments, the bank can redeem the value of loan through sale of those assets. Understandably, the value of these assets should be equal to or more than the value of loan so that the bank does not suffer any loss in the event of default.

Let's look at a scenario where a bottle manufacturer seeks a loan of ₹50 lakhs for two new machines costing ₹70 lakhs. The banker wants a security of ₹1 crores for granting the loan

of ₹50 lakhs. For the security, the banker proposes to charge the machinery to be acquired under the loan. Now since the value of machinery is ₹70 lakhs, there is a shortfall of ₹30 lakhs for which the banker proposes to charge the residential flat of the borrower.

Primary Security

Those assets which are created through the loan are normally charged by the banks as primary security. In the present scenario, the two machines shall be primary security.

Collateral Security

The assets other than primary security which are charged by the bank against the loan fall under collateral security. The residential flat in our example is not a part of the project which is to be funded, and hence acts as collateral security for the banker.

Now how does the banker decide how much security is required for a loan. This is assessed through the *Asset Coverage Ratio (ACR)* which is calculated by dividing total assets available to be charged for the loan by the loan amount. Every bank has a different minimum value for ACR and in our example, the project's ACR shall be around 2 (1,00,00,000/50,00,000). If the bank's ACR requirement would be less than 2, this security may be sufficient for the loan.

It has been seen that some baseless myths are associated with security like:

Myth #1. I do not have security to provide for loan. No bank will fund my project.

Apart from physical security which is charged by every banker, the banks may provide you, collateral free loan under CGTMSE by charging an Annual Guarantee Fee. Even if you have no external security for your loan, you can discuss with your banker to cover your loan under CGTMSE. More on CGTMSE is discussed in coming chapters.

Myth #2. Banks only demand property as collateral security.

This is not true. Apart from immovable property, some banks may also accept FDRs, shares, jewellery, etc as collateral security.

Myth #3: Even if I have collateral security available, it's better not to provide any security to bank.

In case you have collateral security, it is always best to provide it as security for your loan because this will fetch you better credit rating and hence lower interest rates.

The security details that we have discussed till now are physical or tangible. On the other hand, there is another type of security called *'reputational collateral'* which is an intangible collateral. It arrives from a borrower's reputation for debt repayment.

A borrower who has a history of timely loan repayments and a good credit score shall have a good reputation for repayments. This can be considered by the lender as a kind of security against the loan and may generate favourable loan terms.

Lender use different means to look for reputational collateral of any applicant. Most common, in India, are credit bureau scores given by the credit rating agencies. These scores are based on the repayment history of the borrower on the different credit facilities availed. There are four Credit Information Companies (CICs) in India - TransUnion CIBIL, Equifax, Experian, and CRIF High Mark. Also, there are credit rating agencies such as CRISIL, Acuite, CARE, etc.

In case there is no collateral available, how does one avail loan?

For easing the pain of MSMEs who have a good repayment track record, are sound in business and have good reputation but do not have any collateral to offer, Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) facilitates collateral free loans. The borrower has to pay a small Annual Security Fee (ASF) to the Trust which is a percentage of its loan amount and in return, the trust provides its guarantee for the loan.

Currently, CGTMSE provides security for loans up to ₹2 crores. For loans above ₹2 crores, the trust offers hybrid security model where credit facility up to ₹ 2 crores can be covered under the scheme while for the remaining amount, collateral security can be provided.

To check how much of your loan can be covered under CGTMSE, you can visit UDAAN portal at https://www.cgtmse.in/. Also, you can see their ASF structure at https://www.cgtmse.in/Default/ViewFile/?id=1607366695729_CGS-I.pdf&path=Page.

Apart from CGTMSE, National Credit Guarantee Trustee Company Ltd [NCGTC] offers credit guarantee for several schemes and products including for Stand-Up India. For learning more about NCGTC, you can visit https://www.ncgtc.in/.

Key Takeaways:

- *Banks secure the loan amounts through security.*
- *The assets acquired through the loan amount are charged by the banks as primary security while those not a part of the project as charged as collateral security.*
- *The amount of security sought against the loan is decided based on Asset Coverage Ratio (ACR) which is a ratio of total assets available against the loan to the loan amount.*
- *The reputation of the borrower in making timely repayments acts as reputational collateral.*
- *CGTMSE provides collateral free loan to the borrower in lieu of an Annual Security Fee.*



When and why to go for bill discounting, TReDS?

It may happen that you take an order to sell your goods and the buyer would not make immediate payment to you. But you may not be willing to wait for the payment as it may hinder your cash flow. In this scenario, you can take the benefit of Bill Discounting.

Consider this scenario:

Ashok has taken an order to sell his goods worth ₹1,00,000 to Pravay who informs him that he cannot make the payment right away but would be doing it after a period of three months. Having a good business relationship with him, Ashok sells his goods and in turn takes a bill in his favour which commits Pravay to be making the payment after the said period. Ashok, however, is in urgent need of money for his day to day business expenses and cannot wait for three months to receive the cash.

In this case, Ashok can avail bill discounting where the banker shall purchase the bill from Ashok while paying him, say ₹98,000, the amount of ₹2,000 being the charge taken by

bank. At the end of the time period, the creditor will take the amount of ₹1,00,000 from Pravay. This is a win-win situation for both Ashok (seller of goods) who receives timely payment to fund his working capital expenses and Pravay (buyer of goods/customer of the bank's client) who gets the desired time period for repayment.

So, now we can define bill discounting as selling of the bills of exchange to a bank, before the maturity time of bill and collect the value of your bills. The value paid for the bills by the bank shall be lower than its par value as that will be the charge taken by bank against bill discounting facility).

For the MSMEs selling goods to corporates/PSUs, there is a dedicated platform to ensure that their payments are made withing 45 days. This platform is called TReDS.

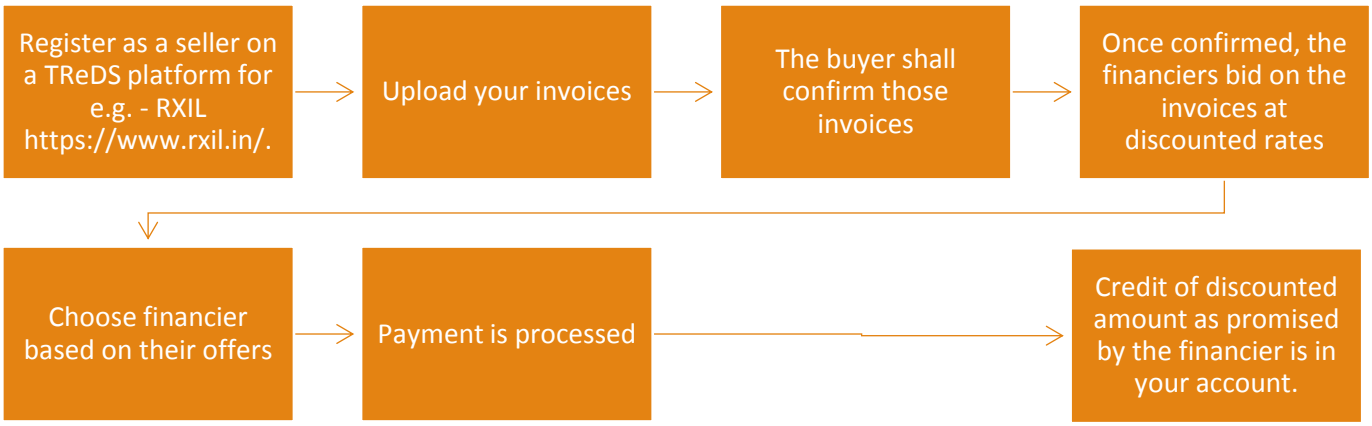
Trade Receivables Discounting System (TReDS)

It is a digital platform to provide online bill discounting to MSMEs.

TReDS platforms authorized by RBI:

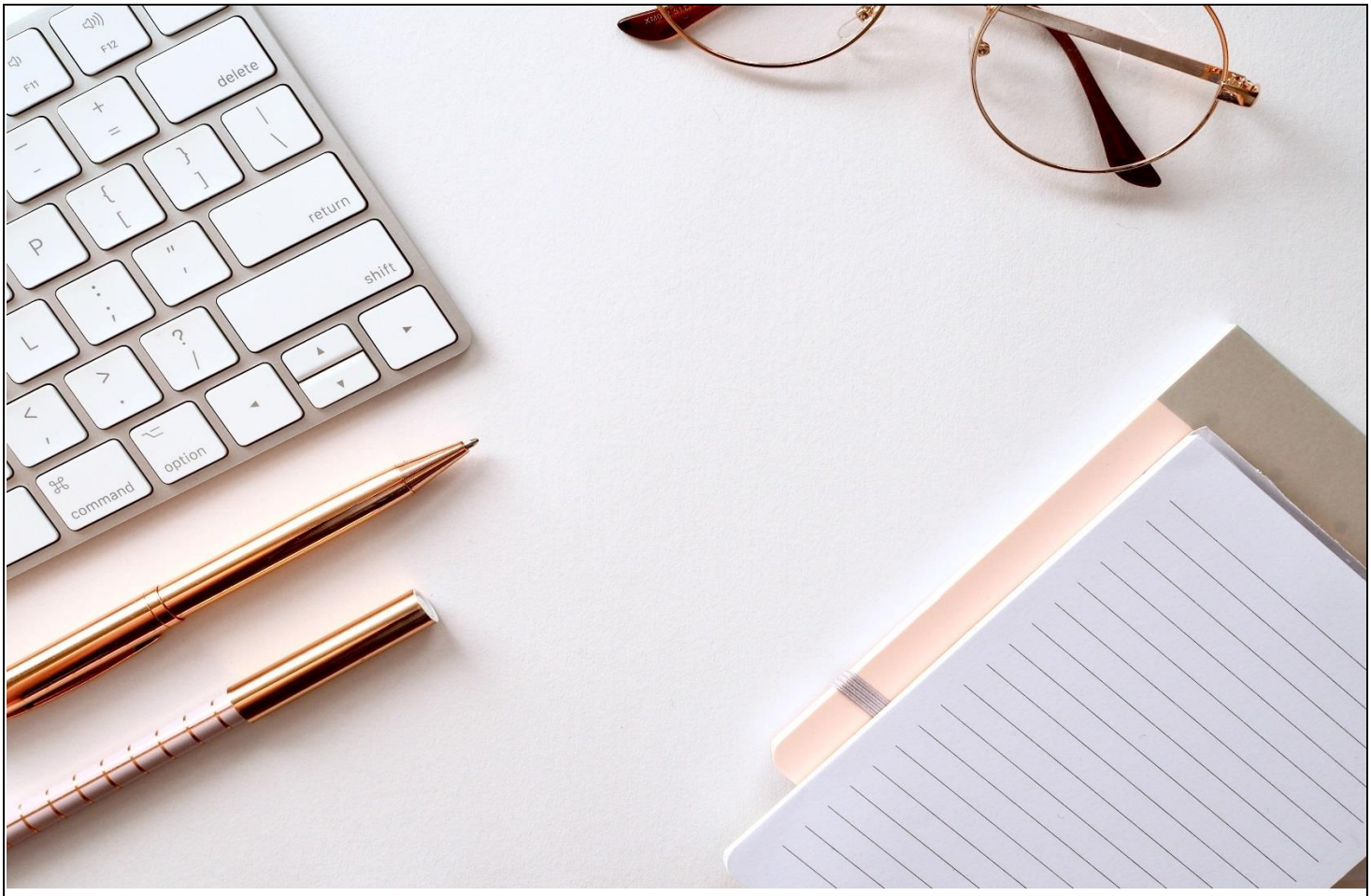
a) Receivables Exchange of India Limited (RXIL)
b) A. TREDS Limited
c) Mynd Solutions Private Limited (M1 Exchange)

How to use TReDS?



Key Takeaways:

- *For the bills on which payment is to be made on a later date, you can get immediate payment through Bill Discounting.*
- *In bill discounting, the bills of payment are taken by the banks and payment is made to the seller after deduction of a fee.*
- *MSMEs can avail the facility online through TReDS.*



Balance sheet and P&L account, Financial ratios which bank look at

If you are afraid of financial accounting, financial statements and ratios, trust me you are not alone.

A lot of entrepreneurs are wary of the financial jargons and leave all the financial management to their accounting personnel. While it's a good idea to have an expert manage your financial accounting, it's always better to know where your business stands and how can you improve if any glitch is observed.

We will try to give you an understanding of these documents and how you can know the health of your business using several ratios so that you can ensure corrective actions if required.

Balance Sheet

Balance sheet provides you the snapshot of a company's financial position on the day of reporting. By reading this document, we can find out what assets are owned by a company and how those assets are financed.

Balance sheet consists of two major sections: Assets (What a company owns) and liabilities (what a company owes) and that the two sections should be balanced at the end of your accounting period.

Take a look at the balance sheet of ABCL:

Balance Sheet as at March 31, 2014 — ₹ million

Particulars	Note No.	As at March 31, 2014		As at March 31, 2013	
EQUITY AND LIABILITIES					
Shareholders' funds					
Share capital	2	170.81		170.81	
Reserves and surplus	3	13,456.20		10,427.33	
			13,627.01		10,598.14
Non-current liabilities					
Long-term borrowings	4	759.47		773.13	
Deferred tax liabilities (net)	5	301.33		195.09	
Long-term provisions	6	369.57		376.41	
			1,430.37		1,344.63
Current liabilities					
Short-term borrowings	7	83.83		98.63	
Trade payables	8	1,277.79		1,362.84	
Other current liabilities	9	2,156.68		1,807.26	
Short-term provisions	6	2,818.73		2,493.20	
			6,337.03		5,761.93
Total			21,394.41		17,704.70
ASSETS					
Non-current assets					
Fixed assets	10				
Tangible assets		6,198.94		3,554.97	
Intangible assets		32.96		33.69	
Capital work-in-progress		1,443.60		1,024.97	
Intangible assets under development		3.14		4.84	
		7,678.64		4,618.47	
Non-current investments	11	160.76		160.76	
Long-term loans and advances	12	567.69		353.52	
Other non-current assets	13	1.22		3.43	
			8,408.31		5,136.18
Current assets					
Inventories	14	3,350.08		2,928.58	
Trade receivables	15	4,527.89		3,806.77	
Cash and bank balances	16	2,945.67		4,107.90	
Short-term loans and advances	12	2,119.30		1,656.78	
Other current assets	13	43.16		68.49	
			12,986.10		12,568.52
Total			21,394.41		17,704.70
Significant accounting policies	1				

Statement on significant accounting policies and notes are an integral part of the financial statements

#The above financial statement is only for example/educational purposes and not for analysis.

On the top of the balance sheet is marked 'as at March 31, 2014'. This statement means that the balance sheet does not report the position for FY 2014 but the position of assets and liabilities as on the date of March 31, 2014.

Now, as we can see, there are two sections of the balance sheet:

a) Assets
b) Equity and Liabilities

Assets

Anything owned by the company is its asset which is expected to have an economic value in the future. Assets can be either current or non-current based on their liquidity. Now we already know what is meant by current assets. Let's discuss non-current assets:

Non-current Assets are the long-term investments of a company like - land, building etc. which have a useful life of more than one year. These assets generate economic value gradually and have lower liquidity, i.e.- if need may arise, they are difficult to be converted to cash immediately by selling. They are required for funding the long-term requirements of a business.

Liabilities

Anything owed by the company is its liability which is an obligation to the company and has to be repaid in future. Liability can be either current or non-current based on when it is due.

Current liability is the one which has to be repaid within a year like – accounts payables (supplier invoices), wages, building rent, interest, tax, etc.

Non-current liability is that which is due after a year like deferred tax, long term loan, etc.

Equity/Shareholder's Equity

The money put into the company by investors (including its promoters) is called Shareholder's Equity. This money belongs to the shareholders and is a liability to the

company as it has to be repaid to its shareholders. It can be calculated by subtracting liabilities from assets.

Liabilities and equity act as capital for the company through which it acquires its assets. Assets provide economic value during their lifetime while liabilities have to be paid off within a particular time.

Taking a look at the balance sheet of ABCL, the Equity portion has two components:

a) Share Capital – The amount of money raised by the company by selling shares to its investors. For example, sale of 1000 share of ₹100 each will fetch the company a share capital of ₹1,00,000.

b) Reserves and Surplus - Any company which makes profit, may provide dividend to its investors as a reward for investing in the company. The profit left after payment of dividend is called reserves and surplus. These are earmarked by the company for specific purpose like debt repayments, etc.

The general rule of balance sheet is:

Assets = Liabilities + Shareholder's Equity

As a rule of thumb, the two sides of the balance sheet should always balance. This is because everything the company owns has to be bought through either shareholder's equity or by borrowing money.

Contingent assets and Contingent Liability

The word contingent means 'probable but not definite'. These assets and liabilities which do not exist today but may fructify due to some event in future.

For example, a disputed tax related court case. Suppose there is an ongoing court case for the company. This shall be a contingent asset for the company which will be realized only if the company wins the case.

On the other hand, let's look at a scenario where the company is a guarantor for some third party's loan. This shall be a continent liability for the company which shall materialize in case the party fails to pay its loan.

Off-Balance Sheet Items

OBS items are those assets or liabilities which are not shown in the balance sheet of the company. Even though not reported in the balance sheet, they are the assets and liabilities for the company. They are not shown since there is no equity or debt linked to them. These items are owned or claimed by an external party.

Benefits of OBS financing

This method is generally used when companies don't want to report large liability in their books. Since balance sheet is all about assets and liabilities, companies are interested in increasing their assets and reducing their liabilities since this will present a good picture before investors as well as creditors.

Let's understand this with an example:
AeY corporation is a tourist management firm and wants to expand by acquiring another office. Since it does not have enough funds to do so, one way of doing the expansion would be by taking a business loan. However, doing so would increase its liability in its books and impact its debt to equity ratio. So, it takes another route and takes an office on lease. Now, there is no impact on the liability figure from this transaction and all it has to do is book rentals in the income statement and show the lease item in its notes. This lease, called operating lease in this case, shall be an off-balance sheet item for AeY corporation.

However, this is important to note that OBS financing should not be used to hide your liabilities from investors or creditors. It should only be done in conformation to the acceptable accounting and legal practices.

Why do we use a balance sheet?

Just like the medical report of a person tells you about health of that individual, balance sheet gives insights about the financial health of an organization.

Through balance sheet, we can derive financial ratios which provide a glimpse of the performance of company, its liquidity, solvency and profitability.

How do I assess the health of my business using the ratios?

There are broadly three types of financial ratios:

Liquidity Ratios

Through these ratios, you can get an idea of how quickly and efficiently your business can pay off its debts/obligations by using its cash or by liquidizing its assets (converting its assets into cash).

a) **Current Ratio**: It measures your company's ability to pay its short-term debt obligations through its current assets.

   Current Ratio = Current Assets/Current Liabilities

   Current Ratio < 1 indicates that your company has not got enough capital in hand to meet all its short-term obligations (if they were all to get due at once).

   Current Ratio > 1 indicates that your company has the financial capability to meet its short-term debt obligations.

   However, a very high current ratio (say >2) may indicate the company's inability in deploying its resources efficiently like having an unsold standing inventory. It may also mean that the company has aged customer receivables (leading to high value of current assets) which may indicate slow payment by its customers. It also indicates that the company is not managing its working capital.

b) **Quick Ratio:** This ratio, also called acid test ratio, measures the ability of a company to pay its short-term debts through its quick assets (current asset minus inventory). Quick assets are more liquid that current assets as inventory is not that easy to be converted to cash quickly. Hence, it indicates a company's ability to pay its current liabilities without having to sell its inventory or getting additional funding.

Quick Ratio = (Current Assets – Inventory)/Current Liabilities

A ratio of 1 means the company is fully equipped to with enough liquid assets to quickly pay off its debt obligations. A ratio less than 1 means that it may not be able to do so while having a ratio more than 1 indicates that the company can instantly get rid of all its short-term debt obligations.

c) **Cash Ratio:** This ratio measures a company's ability to pay its short-term debts using only cash and cash equivalents.

Cash Ratio = (Cash and cash equivalents)/Current Liabilities.

Cash and cash equivalents being the most liquid assets, this ratio gives an idea how fast a company can pay off its current debts if the need may arise using only cash and cash equivalents and without having to sell or liquidate any of its assets. It helps the creditors in determining the company's ability to pay its debts in the worst-case scenario.

<1 means the company does not have enough cash/CEs to pay off its current liabilities.
=1 means the company has the same amount of cash/CEs s as its current liabilities.
>1 means the company shall have cash/CEs at its disposal even after paying off all of its current liabilities.

However, a very high cash ratio may indicate the company is not utilizing its cash resources efficiently and not maximizing its profit by availing low cost loans. The cash resources may be parked uselessly in the bank instead of being invested in profitable projects.

***Ratios are most meaningful when analysed in the context of the company's industry and its competitors*.

Solvency Ratios

While liquidity ratios assess the capability of a company to quickly pay off its short-term debt obligations, solvency ratios look at the ability of a company to honour its long-term liabilities. A solvent company is the one which owns more than what it owes.

a) Debt to Equity Ratio (DER)

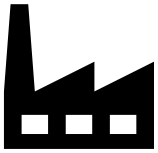
DER = Total debt (long term + short term) / Shareholder's equity.

This ratio is a measure of how much of the operations of the company are financed through debt (borrowing) and how much through equity (wholly owned funds). A highly leveraged company, i.e.- one whose operations are funded more by borrowing than by its own money, will be riskier than the one which manages its operations mostly by its own funds.

It is also indicative of the ability of a company to pay off all its outstanding debt obligations through its owned funds if such a need may arise.

Example:

Company A



$$\text{DER (2.4)} = \frac{1200000 \text{ (business loans)}}{500000 \text{ (Equity)}}$$

Highly leveraged company

Company B



$$\text{DER (1)} = \frac{500000 \text{ (business loans)}}{500000 \text{ (Equity)}}$$

Low leveraged company

Generally, financiers desire DER to be less than or equal to 2. A DER of 2 would imply that 2/3 of the company's capital is being financed by debt and 1/3 by shareholder's equity.

b) Debt to Asset Ratio

This ratio is indicative of what percentage of a company's assets have been financed through debt. Higher value would indicate higher leverage and hence higher financial risk. Hence, the lower the DAR, the safer it is for the lender.

Debt to Asset Ratio = [Total Debt/Total Assets]

- A ratio of 1 would mean all the assets of that company are financed by taking debt. If required to pay all its debt at once, it will have to sell all its assets. Such a company will be deemed risky by the creditor as it has almost no scope of taking more debt.
- A ratio less than 1 would mean the company has taken more debt than the assets it has. If there is a need to pay its debts at once, it would not have sufficient resources to do so. Such a company is highly leveraged and would not be considered suitable by the creditor to lend.
- A ratio more than 1 would signify that the company owns more assets than its debt and can comfortably pay off all its debts without having to sell all its assets.

c) Interest Coverage Ratio (ICR)

Tells about a company's ability to keep paying interest on its debt obligations. This is a critical ratio since any company which is not in a position repay even the interest on its loans (existing/future) may be on the verge of financial bankruptcy.

ICR = [Operating Income (Earnings before interest and taxes) / Interest expense]

The value indicates how many times the company can pay its interest obligations using its earnings. Low value would indicate it doesn't earn enough to pay its interests and cannot be considered safe to lend.

d) Debt Service Coverage Ratio (DSCR)

This ratio tells us how much cash flow is available with the company to pay all its debt obligations and the costs associated with them. This is also one of the key figures a banker would look at when trying to estimate your loan eligibility as it tells him whether the borrower has enough income to repay all its debts including principal and interest repayments on the all the existing as well as future liabilities.

DSCR = [Annual Net Operating Income) / Debt Service]

Annual Net Operating Income = This is the income that is left after all the operating expenses are paid. This is calculated as Net Income + Interest + Tax + Depreciation + Amortization

Debt Service = Refers to all the costs associated with the company's debt. This is calculated as Principal & Interest on debt payment + Lease Payments to be done during a year.

Let's calculate the DSCR for XYZ Limited:

First, we need to calculate the net operating income:

	Amount (in Rs.)
Sales (Total Income)	500000
Cost of Goods Sold	150000
Gross Income	350000
Selling, general and administrative expenses	40000
Other operating expenses	10000
Operating Income	300000
Interest expenses	20000
Profit before interest	280000
Tax provision	10000
PBIT	270000
Depreciation	10000
Amortization	10000
Net Operating Income (PBITDA)	**250000**

The second step shall be calculation of the debt service:

	Amount (in Rs.)
Annual principal repayment	100000
Interest expenses	20000
Debt service	**120000**

DSCR = 120000 / 70000 = 1.71

This DSCR more than 1 is generally comfortable for the lender as higher the ratio, the greater the ability of the borrower to repay the loan. A DSCR of less than one, say 0.95, would imply that the borrower possesses only enough net operating income to cover

95% of its annual debt obligations. This would mean that he would not be able to service the loan payments without borrowing more.

Profitability Ratios

These ratios help assess a company's ability to generate profits relative to its revenues, balance sheet assets, operating costs, or shareholder's equity over time. More ability will understandably mean more profitability.

a) Operating Profit Margin or EBITDA Margin

This calculates how much operating profit is earned by the company per rupee of the revenue generated from its operations and hence lets us know how profitable a company is at the operating level.

In other words, it tells us how efficient the management is in managing expenses to generate maximum revenue for the company.

To calculate EBITDA Margin, we shall need to calculate EBITDA first:

EBITDA = Operating Revenue – Operating Expenses.

Operating Revenue = Total Revenue – Other Income.

Operating Expenses = Total expenses – finance cost – depreciation – amortization.

*EBITDA Margin = [(EBITDA)/Operating Revenue) * 100*

b) Net Profit Margin or PAT Margin

While the Operating profit margin looks at the profit at operating level, PAT Margin is calculated at the final profitability level. Operating level considers only the operating expenses but ignores other expenses like depreciation, amortization, tax and finance expenses.

For calculation of total final profitability, we exclude all expenses from total revenue.

*PAT Margin = (PAT / Total Revenue) * 100*

Where PAT = Total Revenue – Total expenses

NPM tells us how much profit is earned per rupee of sales and hence is indicative of a company's overall ability to turn income into profit.

c) Return on Assets

RoA is the earning on per rupee of assets invested in the company. Calculating how much net profit is earned per rupee of assets owned by the company and hence, it tells us the efficiency with which a company is utilizing its assets to generate profit for the company.

RoA = Net Income / Total Assets

d) Return on Equity:

RoE is the earning on per rupee of shareholder's equity available in the company. It gives us the net profit earned per rupee of shareholder's equity invested in the business and hence indicates how efficiently the company is utilizing its shareholder's equity capital in generating profit for the company.

RoE = Net Income / Shareholder's equity

There are many more ratios and they are interrelated; these ratios play a very important role in determining your credit ratings and ultimately is a deciding factor for your credit eligibility and interest rates. Most of the time simple over looks by the promoter like diversion of long-term fund for short term expenses, non-proper management of inventory etc. result in a dent in the ratios. A promoter must keep a watch on Balance sheet, Profit and loss statement on a regular basis to be cherry picked by Financers.

Now let us look at another one of the important financial statements which is the P&L statement:

Profit and Loss Statement

P&L statement provides the summary of a company's revenue and costs/expenses incurred over a period of time. It provides insights on:

a) How much profit was generated over the given period.
b) How much expenses were incurred in generating that profit during the period.
c) Depreciation and tax.

Coming to the P&L statement of ABCL:

Statement of Profit and Loss for the year ended March 31,2014 — ₹ million

Particulars	Note No.	Year ended March 31, 2014	Year ended March 31, 2013
REVENUE			
Sale of products		38,041.27	32,949.37
Less: Excise duty		4,005.15	3,512.45
Net sale of products		34,036.12	29,436.92
Sale of services		309.32	137.02
Other operating revenue		21.15	15.21
Net revenue from operations	17	34,366.59	29,589.15
Other income	18	455.14	465.51
Total Revenue		**34,821.73**	**30,054.66**
EXPENSES			
Cost of materials consumed	19	21,011.95	17,603.12
Purchases of stock-in-trade	20	2,113.69	2,632.54
Changes in inventories of finished goods, work-in-process and stock-in-trade	20	(292.10)	(320.89)
Employee benefits expense	21	1,583.16	1,262.30
Finance costs	22	7.18	2.69
Depreciation and amortisation expense [includes impairment loss of ₹Nil (PY ₹75.52 million)]	23	645.71	660.92
Other expenses	24	4,346.60	3,904.24
Total Expenses		**29,416.19**	**25,744.92**
Profit before exceptional items and tax		**5,405.54**	**4,309.74**
Less: Exceptional items (net)	33	38.84	91.57
Profit before tax		**5,366.70**	**4,218.17**
Less: Tax expense			
Current tax		1,580.00	1,377.97
Deferred tax (credit) / expense		106.23	(24.51)
Earlier year's (excess) / short provision		6.11	(2.34)
Profit for the year		**3,674.36**	**2,867.05**
Basic and diluted earnings per equity share of ₹1 each	37	21.51	16.78

#The above financial statement is only for example/educational purposes and not for analysis.

Highlights of P&L statement:

a) As understood by the heading of the statement, 'Statement of Profit and Loss for the year ended March 31, 2014', the P&L statement looks over the events of the whole period.

b) As can be seen, the statement is comparative. On the left are the figures for the current year, while on the right are those of the previous year. This can help assess the position of the company with respect to the previous year.

Components of P&L Statement:

Revenue Side

The revenue side contains:

1. The income is generated by sales of products.
2. Excise duty is deducted as it is an outgo for the company.
3. Net sale of the product is the income generated by sale of product minus the excise duty expenses.
4. The income from sale of services.
5. Any other revenue generated by the operations of the company.
6. The net revenue from operations shall be = sales of goods + sales of services + other operating revenue which will provide us total operating revenue. This is the revenue generated by the company through its operations.
7. Other income shall mean all income generated from activities other than the operations of the company. This can be the profits generated by any investments done by the company.
8. Total revenue is operating revenue plus other income.

Expense Side

The expense side contains:

1. Cost of goods consumed (Expense done in purchase of raw material)
2. purchases of stock in trade (expense done in purchasing of finished goods by the company for conducting its business)
3. Changes in inventories of finished goods: The costs of manufacturing were incurred in the past, but sales of those goods were done in the current year. This is negative in our example which indicates that the company could not sell all of the goods that were manufactured last year.
4. Employee Befit Expenses: The expenses incurred in salaries, PFs etc.
5. Finance costs: The interest and other costs incurred over the money borrowed.

6. Depreciation and Amortization: To understand this head, let's look at tangible and intangible Assets:
    a. Tangible Assets: Which has a physical form and provides an economic value to the company – building, machinery, vehicle, equipment, etc.
    b. Intangible Assets: Has no physical form but still is of economic importance to the company – goodwill, trademark, copyright, etc.

Both tangible and intangible assets reduce in value over time. The duration in which it provides economic value to the company is its useful life. The useful life of assets varies as per their nature. The asset which is purchased this year continues to provide economic value during its useful life. Therefore, the expense incurred in purchasing such assets is distributed over the period of its useful life. This is called depreciation.
The same can be done for non-tangible assets and this process is called amortization.

1. Other expenses: These include the manufacturing, selling and other expenses of the company.

Using the P&L statement, we can calculate several figures like:

a) Gross Profit = Revenue – Cost of Goods Sold (COGS)
b) Profit before tax, PBT = (Gross Profit - Expenses)
c) Profit after tax, PAT = PBT – tax expenses

Analysing these figures, owners and managers can now make informed business choices to:

- Allocate human resources
- Continue or discontinue certain activities of the business
- Purchase or rent certain equipment used for the production of goods/services

Prudent Financial Management – Do's and Don'ts

Do's

a) Keep your personal finances separate from your business finances

Especially if yours is a proprietorship firm, it may feel easy to keep everything going from the same account. However, this can lead to cash flow issues, taxation and legal issues if not handled separately.

b) Have a skilled staff handle your book-keeping and accounting

Every businessman who starts on his own generally keeps the financial handling to himself in the beginning. But as the business grows, it is tedious to follow everything and may lead to errors, losses, delays and penalties. It's a good practice to have not only a dedicated book-keeping staff for the day to day recording of your financial transactions, but also accounting staff for preparation of your financial statements.

c) Employ online tools for the accounting department

Gone are those days where every financial recording was done manually. There are useful tools and softwares which will give power in your staff's hands to prepare error free financial statements swiftly and efficiently.

d) Establish the type of accounting to be used

There can be two ways for following accounting – cash-based and accruals based. In cash-based method, accounting is done as the cash is actually received or spent and is useful for the businesses dealing mostly in cash.

On the other hand, accruals-based accounting records the income when it is earned and expenses when they are consumed or when invoiced, whether actual cash transaction happens or not. This method is useful for businesses working in credit by invoicing their clients.

e) Periodically close your books

Make it a habit of closing your books after every month to monitor the performance of your business. This habit will help you to analyze, plan ahead and do any modifications if needed.

Don'ts

a) Starting without a budget

If you start the fiscal year without a budget, you are likely to make poor financial decisions.

b) Having no internal controls

It is important that there is no clash of duties in your financial department. The person who has the authority to sign cheques should not be in control of your businesses' cheque book.

c) Not having defined procedures

There should be clearly defined ways in which business is to be performed by each department.

d) Not following up on credit invoices and receivables

Just because you have sent an invoice, it does not mean that you will receive money. Instead of having to run behind your customers at the end of accounting year, be sure to regularly follow up and ensure timely payments.

e) Not recording income when received

If you don't book your income when you receive it, it can turn into a pile of receipts at the end of year and can lead to underreporting of income and hence underpayment of taxes. So, it is always advisable to keep a tab of your income and maintain a regular record.

Key Takeaways:

- *Financial statements help us know the financial position of a company.*
- *Two key financial statements are balance sheet and P&L statement.*

- *While balance sheet provides a picture of what the company owns (assets) and what it owes (liabilities) on a particular date, P&L statement provide an idea of the profitability of a company during a period of time.*
- *By maintain a check on the financial statements and by following positive practices, a business can increase its profitability and make itself attractive for investors and creditors.*
- *Don't ever fall prey to any strategy which shows false picture of your financials.*
- *Transparency shall take your business to new heights and will ensure that you can avoid the vicious cycle of hurries and worries.*



BREATHE in success- when and how to diversify/expand- what are critical aspects

When you started your business, it may be quite easy to identify the things you need like that office building, new factory premise, staff, furniture, etc. However, once you have got your business running for a while, it become a bit tricky to identify exactly when should you plan an expansion or diversification. In this chapter, we will provide you with a guide with signs to look after if you think it may be time to hit the expansion road.

Sign #1: You have a steady flow of customers

In other words, you should have loyal customer base along with a steady flow of new customers getting added regularly for better dispersion of associated risk.

Sign #2: Your customers have been demanding it

If your customers keep asking you to get that new product, or start serving in a particular location, it's time to think about diversification by adding another product/service or expansion by starting your production in another location.

Sign #3: You have a shortage of help

This has to do with your staff. If you seem to be overflooded with customer requests and you have to keep their orders on hold due to shortage of people to help you with, maybe it's time to start looking for adding staff in your business. This will not only help in customer retention, but quicker service delivery may translate to better market reputation.

Sign #4: Your industry is growing

If new trends are coming in your industry, your customers will demand from you to update your business. In such a scenario, it is a good idea to look for diversification into new areas so as to keep yourself up to date with the industry trends and retain your customer base.

Sign #5: There is a business outpour

You have too much a business which is absolutely a wonderful thing. However, if that space is becoming too tight for the extra orders / overflowing demand, you should think about increasing your space or look for new locations to serve your customers.

Sign #6: Your systems are getting outdated

This can be understood in the following way: suppose your business is still being done manually while there are a lot of new technologies available in the market which are being used by your industry peers that can save your time and improve the quality of your products/services. In such a case, it is definitely a good idea to go for revamping of your processes and keep them to their most optimum level of output.

Sign #7: You've got a great idea that you know is going to work well

Take the scenario of covid-19. During the pandemic while a lot of businesses were shut down, some businesses started launching products which they knew were going to be in great demand during the crisis time. And went for expansion at a time when the market was on a low. Similarly, if there is a great idea which should improve your profitability and will take your business to new heights, it's time to hop on the expansion/diversification wagon.

Sign #8: If you don't possess the necessary skills to do a particular job

Let us understand this by an example. Suppose when you started your business, it might be quite small and maybe you did all the accounting work yourself. However, as u graduated to a larger enterprise, the calculations become complex and it may not be possible for you to understand all the nitty gritty of the accounting now. You can then start thinking about hiring a skilled employee or install an efficient software to do that work in an efficient and quick manner.

Sign #9: You have unused funds parked in your bank

It's a good idea to have enough liquidity so that the day to day operations of your business don't come to a standstill. However, just letting the extra money to lie unused can also mean that you are losing an opportunity to let that money grow by opportune investment which can lead to increase the profitability of your business. So, it can be a good idea to use that extra cash in some well thought investment.

Sign #10: There is a great opportunity around

In cases, when there is a good business opportunity in front of you which you cannot ignore, you should definitely give expansion / diversification a thought. In present scenario of competitiveness, the businesses which take calculated risks are the ones which come out with flying colors.

Key Takeaways:

- *Any business needs to keep expanding / diversifying in order to survive in the volatile and competitive business environment.*
- *You should keep your eyes and ears open to analyse whether it is time for expansion or diversification.*



Breaking the barriers - Cashflows and fund flows, IRR, break even

For a Business to run successfully, management of cash flow & fund flow is one of the basic requirements.

What is Cash flows?

In a simple way, cash flow is the amount of money coming into a business and the amount of money going out.

Cash Flow Statement

Cash flow statement tells how much cash the company is generating in its revenue. Let's understand this by an example:

Hello India is a seller of mobile phones, each of which costs ₹1000. During a particular day, Hello India sold 100 mobile phones, thus making a sale of ₹1,00,000. However, while 70 customers paid in cash, 30 of the customers paid in credit, i.e.- promised to pay at a later date. So, while the total sales on the day is ₹1,00,000, the sales in cash is only ₹70,000. Now, if the company had an urgent loan obligation of ₹80,000, it would be in cash crunch despite making a sale of ₹1,00,000.

This is what is captured by a cash flow statement. A company's profitability is not dependent just on its revenues, but its cash flows or liquidity. Cash flow statement assesses whether a company has enough cash at all times to fund its operations and pay its debts.

Components of Cash Flow Statement:

a) Cash from operating activities
b) Cash from investing activities.
c) Cash from financing activities

Consider the example of a well-established eatery like Café Coffee Day. The business activities performed by such an eatery can be:

a) Printing of menus, pamphlets, etc.
b) Display of advertisements with attractive offers.
c) Procurement of raw materials for the café like coffee beans, flour, sugar, milk, etc.
d) Hiring and training of staff.
e) Procure equipments like vending machine, stove, etc.
f) Buy furniture and other decorative items to improve the ambience.
g) Seek short term loans from bankers.
h) Issue new shares to raise money from the public.
i) Invest excess money, if any, in FDs, etc.
j) Invest in any upcoming property for opening new store in future.

These business activities can be classified as:

A) Operational Activities: Activities related to day to day operations of the business which include sales, marketing, hiring, training, manufacturing, etc. In our example they will be a, b, c, d, e and f.

B) Investing Activities: When the company invests its money in order to make profit at a later date. Those in our example shall be i and j.

C) Financing Activities: The activities include all the financial transactions of the company, i.e. g and h.

Each of these activities shall has an impact on cash possessed by the company. Some will lead to increase in the cash flow of company while others may lead to decrease. For example, while short term loans and market money shall increase the cash, investment in new building and procurement of equipments shall decrease the cash.

Hence the total cash flow of the company shall be:

Net cash flow from operating activities + net cash flow from financing activities + net cash flow from investing activities.

Fund Flows

While cash flow looks at the net inflow/outflow of cash in the business, fund flow compares the fund position at the beginning and the end of the year to analyse what were the sources of funds (liabilities and equity capital) and what was the utilization (assets) of those funds.

To understand this further, let us look at an example:

If there is an increase in the asset side of balance sheet, it means that the company has spent some funds to create assets. This shall imply fund outflow. On the other hand, if there is a decrease in the asset side, it would mean the company has sold some assets to maintain its fund inflow.
Similarly, on the liabilities side, if there is an increase over the previous year, it would mean there is an increase in fund inflow which would lead to fund outflow on a later date.

Importance of fund flow statement

The prime importance of this statement is that it helps in assessing the financial needs of the company and the best ways to finance those needs.

It also analyses the changes in working capital during the two accounting periods and thus we can interpret in advance whether we have adequate working capital.

On a different note, let's talk about the returns in your business investment.

Internal Rate of Return (IRR)

Whenever you invest money in your business, your main motive will be to earn profit on that money, isn't it? This means that whenever you look for a new investment, it would be great to know in advance the returns that investment would generate so that you can choose the one with the most profit potential.

Internal rate of return is the metric used in calculating this profitability. It gives you the annual rate of growth which an investment will generate. Using this, you can compare different investments and choose the one with the highest IRR.

How to calculate IRR?

To understand this, we need to keep an important concept in mind:

Value of one rupee today will be less than the value of same rupee in the future.

This concept is basically called *Time Value of Money* and it is based on the premise that if you give people option to receive ₹1 lakh today or ₹1 lakh after 2 years, people would accept the first option due to the intrinsic benefits of receiving money sooner than later.

One such benefit can be the opportunity to grow that money by keeping it in savings account or by investing in a profitable instrument. Other factor the money received later is not attractive is due to inflation which leads to reduction in the purchasing power of money.

For example, if you invest ₹100000, you will earn 100000 + interest (say 10000) = ₹110000 in the future. Now how would you know whether the value of ₹110000 in the future is more than the value of the ₹100000 today? This is done by calculating the Present Value

of ₹ 110000 (the future value of 100000) and comparing it with 100000 (your initial investment). If the Present Value is more, the investment is profitable.

To compare this, we calculate the rate at which both the values become equal, or in other words, the Net Present Value (Present value of your final amount minus your initial investment) is zero. This rate at which the NPV becomes zero is called Internal Rate of Return (IRR). This will tell you the rate of return at which the future cash flows from your investment will become equal to your cost of investment. Generally, the higher the IRR, the more desirable is an investment.

Manual IRR calculation cannot be done directly and has to be done either through hit and trial method or through excel.

While IRR tells you whether your investment will be profitable, Break-even point tells you when it will become profitable.

Break-Even Point

When you plan a business, it takes some time to become profitable. Before that, your cash outflow (costs/expenses) are greater than your cash inflow (revenue) and your business may be making losses. However, with the gradual running of business, the costs will decrease, and the revenue will increase finally meeting at a point when both become equal.

This point is called break-even point when you are neither making profit nor any loss. This is a critical point in your business as after this, the business shall start generating profit.

Why do I need to know the Break-Even Point of my business?

The break-even point allows a company to know how many units it need to produce or how much sales it need to make to start getting profitable. Having an idea about the BEP will help you align your business in that direction.

Further, when you go to a banker for a loan on your new project, the banker shall also calculate the BEP of that project so that they can see when your business shall generate positive cash flows so that timely repayment of its loan can be assured.

How to calculate the BEP?

Let us say Roli is a jewellery maker in a small town of UP. She plans to introduce new designs for office going ladies and wants to know whether it will be profitable for her business. So, she calculates the BEP of this new project.

To calculate how many units, she needs to sell to reach BEP, the formula is:

BEP = Fixed Costs / (Sale price per unit – Variable costs per unit)

Fixed costs will be the ones which do not change like monthly rent, electricity/telephone bill, etc.

Sale price per unit is the price to be charged from the customer for single unit.

Variable Costs per unit are the costs directly linked to the production of single unit like labour costs, material used, etc.

For Roli, the costs for the first month of production are:

Fixed costs = ₹200000

Sale price per unit = ₹15000

Variable costs per unit = ₹5000

The BEP shall be = 200000 / (15000-5000) = 20

This shall mean that Roli will need to sell 20 pieces of the new jewellery in the first month to achieve break-even.

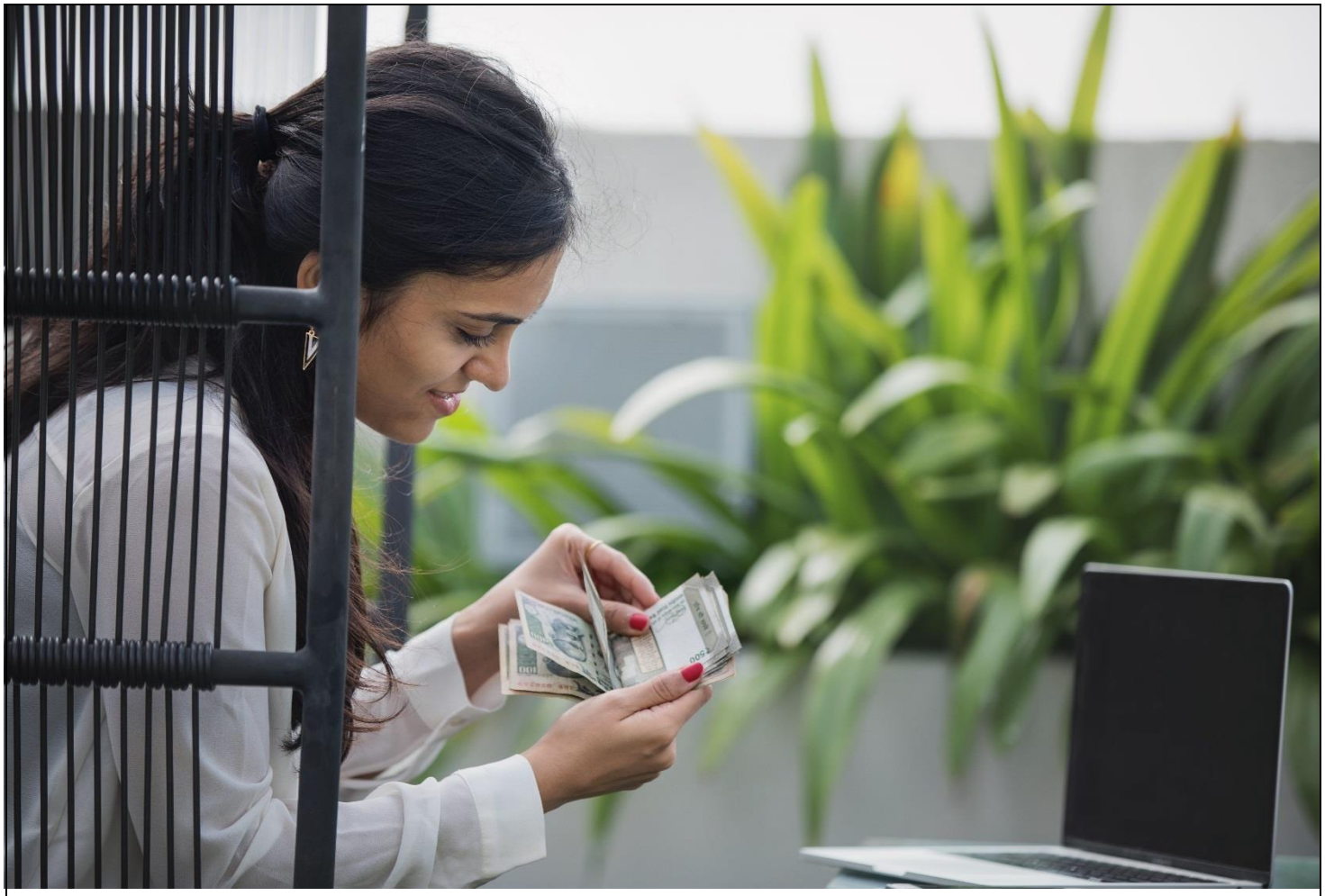
Selling 20 units in the first month seems a bit tough to Roli. Still BEP can be achieved through the following ways:

1. Reduce the fixed costs: This could be done through negotiations such as reductions in rent payments or through better management of bills or other costs.

2. Reduce the variable costs: This could be done by finding a new supplier that provides raw material at a lower cost.

Key Takeaways:

- *Cash flow statement tells you how much cash is being generated out of the total profit of your company.*
- *By analyzing the cash flow statement, you can understand whether you have enough cash in hand to fund your operations and pay your debts*
- *Fund flow statement compares the cash flow position at the beginning of the accounting period to the position at the end of the period.*
- *Through the fund flow statement, you can understand your sources of funds and the utilization of each source of fund.*
- *Internal Rate of return is the rate at which the present value of your future cash flows is equal to the value of your initial investment.*
- *IRR is used to decide on an investment or compare between two investment.*
- *Higher IRR Is desirable.*
- *Break Even Point is that level of production when your cost of production equals the revenues generated by your operations.*
- *At BEP the business is making neither profit nor loss.*
- *Generally, the business shall start making profits after BEP. Lower BEP is desirable.*



Unwinding the knots- Aspects of financial leveraging – why it is necessary for growing units?

If you have to lift a heavy rock with your bare hands, it would be extremely difficult, provided you manage to do so. To make that task simple, if you use a lever, you can do the same task easily with minimum effort. This is because the lever will multiply the efforts you put into moving the object and provide you maximum results.

Or in other words, it will provide you leverage.

In the world of finance, the same concept is replicated by financial leverage.

The strength provided by borrowed money or debt to acquire assets and which shall multiply the profits generated by the company is called financial leverage.

This happens when the cost of debt is lower than the returns on assets acquired by that debt.

How is financial leveraging important for me?

- When used wisely, leverage can multiply the profits generated by your company.
- Through using various ratios which we will discuss later, you can make the best financing and investment decisions for your business.
- Leverage can also help you in determining the amount of expansion you can do for your business. For example, it can be used to recommend restrictions on business expansion once you realise that the projected return on additional investment is lower than cost of debt.
- Financial leverage locates the correct and profitable financial decision regarding capital structure of the company, i.e. how much of the assets need to be funded by taking debt and how much to be funded using equity.

How can I ensure the optimum level of financial leverage for my business?

To determine how much of debt can be infused in the business, we use several ratios like Debt Equity Ratio, Debt Ratio, Interest Coverage Ratio and Degree of Financial Leverage (DFL). The three ratios of DER, Debt Ratio and ICR have been already discussed and can be used accordingly to understand how much more debt can be infused in the company without damaging its profitability. Let's discuss about DFL.

Degree of Financial Leverage (DFL)

This gives us an idea about the sensitivity of the profitability of a business to the change in its capital structure. Through this figure, we can analyse how much money can be borrowed without negatively affecting the earnings of our business.

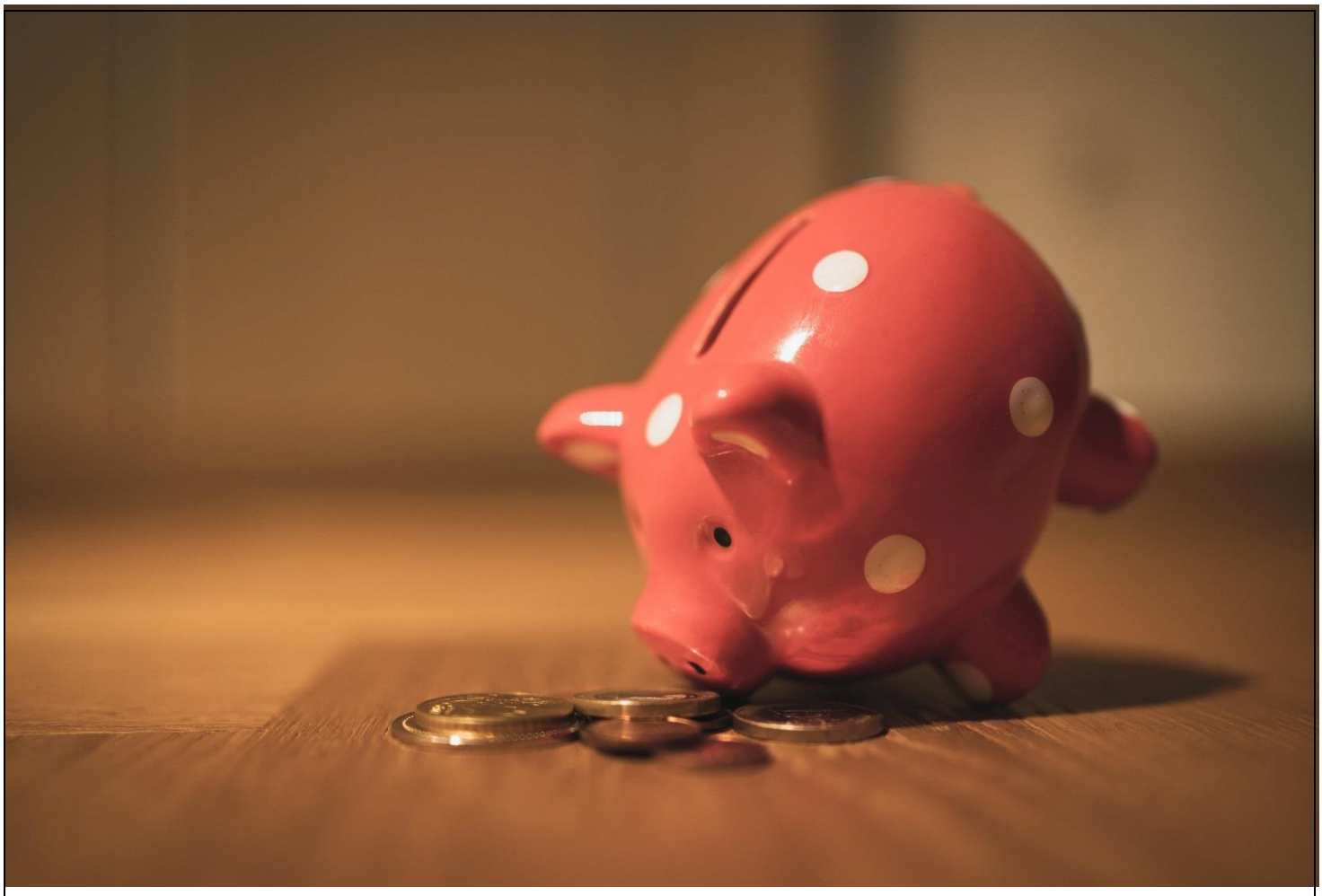
DFL = Earnings before interest and tax (EBIT) /(EBIT – Interest)
Looking at an example,

Suppose Vayu Corporation plans to expand by acquiring a new office. Since it needs external financing for this expansion, it decides to see how much money can be borrowed without negatively impacting the operating income.

To analyze this, the management decides to compute its DFL. The present EBIT of the company is ₹5,00,000 and its interest expenditure is ₹1,00,000. So, the DFL can be calculated as ₹5,00,000 / (₹5,00,000 -₹1,00,000) = 1.25. This means that for every 1% change in the company's leverage, its earnings will change by 1.25%.

Key Takeaways:

- *Financial Leverage is important to multiply the profitability of your business.*
- *Through various ratios like DER, Debt Ratio, ICR and DFL, we can estimate how much debt can be taken to increase the profitability of business to the most optimum level.*
- *By maintaining optimum level of financial leverage, you can ensure the interest of creditors in providing debt at attractive terms for your business.*



Looking for internal sources of finance- what to look at. When and how to declare dividend?

Finance as we have understood, is a very important component for the growth of any business. While till now we have been focusing on the external sources of finance, there are several other sources which are originated by the business in its normal course of operations. These are called Internal Sources of Finance.

Types of Internal Sources of Finance

Owner's Fund

This is the money owner brings from his own pockets to invest in the business. This money generally comes from his personal savings and does not cost anything to the business.

Retained Earnings

Out of the profits made, the business may declare dividends to its investors. The remaining amount left after giving dividends which is kept by the business to reinvest in new projects or to pay any dues is called retained earnings. This money can be utilized as internal source of finance.

Sale of Assets

At times the business can sell off some of its assets to generate money which it can invest in the business. This is another internal source of finance with one drawback that the assets are generally sold off before their useful life.

Reduction in working capital.

This can be achieved by either speeding up the account receivables or delaying your account payables. Both can be done by negotiations and thus depend on your management capabilities. Both shall lead to lower working capital requirements and hence will lead to more cash in hand free for financing your business investments.

During the topic on retained earnings, we talked about dividends. Let's take a more detailed look over this topic.

When a company makes profit, it saves some of it in the form of retained earnings for the purpose of reinvestment/payment of debts, etc. The remaining amount may be distributed by the company to its shareholders as a reward for investing their money in the business. This is called dividend and a company may or may not declare it based on its profitability or investment decisions.

When to declare dividends?

A public limited company under Companies Act, 2013 may declare dividends to its shareholders at an amount which is finalized by the board of directors.

The payment is made from profits made or accumulated earnings of the business over the years.

A company which has made no profit may still declare dividends in order to retain its investors.

How to declare dividends?

If a company has excess earnings and decides to pay dividends, it broadly follows these steps:

a) The board of directors approve the amount of dividend and date of payment.
b) Declaration of the amount of dividend and the record date and payment date. Record date is the day on which one has to be a shareholder in order to receive the dividend. Payment date is the day on which the shareholders who hold the share before record date receive the dividend.
c) Dividends can be either paid out in cash or in additional shares.
d) On the day of payment, the company deposits the amount with the depository which are then forwarded to the brokerage firms where shareholders hold the company's shares.

Key Takeaways:

- *With good management, a business can generate its own sources of funds.*
- *Internal sources of finance will lead to lower cost of funds, better working capital management, lower interest costs and hence may lead to overall profitability.*
- *A public limited company may decide to declare dividends to its shareholders as a reward for investing their money in the business.*
- *A company that pays a consistent dividend attracts a lot of investors and hence ensures steady source of equity financing in the business. It also leads to good reputation which helps in debt financing by the creditors.*



Responsible financing – what's great about this?

From the point of view of a financial institution (FI), Responsible Financing has the following components:

a) Good governance
b) Strong emphasis on capital preservation and its quality
c) Effective risk management
d) Proactive Environmental & Social (E&S) intervention through investment and lending.

All these four components are intrinsic to Banks's / Financial institution's (FIs) business.

Why is it important?

Business must be responsive to the society, rules/laws of operating eco-system as well as aligned to the national/global expectation. The objective of responsible financing is to ensure that any adverse environmental and social impacts from an activity are avoided or appropriately mitigated and compensated.

How it is crucial for me, as an entrepreneur?

When you approach a bank for funding of your project, the banker may look for the following responsible financing standards:

1. Risk management: Does your project pose any risk to the environment or the society? If yes, there must be a proper strategy in place to mitigate this impact.

    a. If there are hazardous equipments being used in your project which can pose a threat to safety of the community, you should install proper mechanisms in place to prevent any such potential injury. If the hazards are life threatening, you should replace or eliminate such equipments.
    b. If the emissions from your project may lead to communicable/non-communicable diseases among the community, you should install treatment plants at your place and regularly monitor them. At time, the influx of labour can lead to spread of diseases which needs to be prevented.
    c. Any private personnel employed at your factories need to be properly scanned for their criminal records and past history so that they do not pose any threat to the safety of community members. Feedbacks need to be regulary taken from the community members about the conduct of such people and corrective actions, if any, should be taken impromptu.

2. Labour and working condition: There should be proper safeguards at your workplace to ensure safer working condition for labour and employees, gender equity and there should not be any forced labour or child labour.

3. Resource efficiency and pollution prevention: The carbon footprint of your business should be reduced by efficient usage of resources and adoption of green technology.

#As an entrepreneur, green Technology shall entail activities which reduce negative impact of your business on the environment. These activities can be:

a) Use of renewable energy like solar energy, wind energy, etc.
b) Reuse and recycling of non-biodegradable products.
c) Installing wastewater treatment, sewage treatment plant at your unit.
d) Reduce any carbon emissions from your factories.
e) Conserve energy by discouraging any wastage of resources

4. Land acquisition and involuntary re-settlement: Re-settlement resulting from a land acquisition is considered involuntary if the community members do not have the right to refuse the acquisition and their resulting displacement. Such involuntary re-settlement, if not handled properly can lead to the businessman finding himself embroiled in legal action.

   It is advisable to carry the re-settlement though negotiation with the affected community, keeping their best interest in mind. You should go for re-designing of your project, if necessary. In case involuntary re-settlement is unavoidable, there should be a proper plan to mitigate any harmful impact and restore the livelihoods and living conditions of the community.

   Responsible financing also stems from responsible attitude of an entrepreneur about his financing requirements. It is critical that any proposal should be scanned through the environmental and social (E&S) requirements and criticalities and necessary mitigation measures to be adopted to comply with the E&S regulatory framework.

Traits of a responsible entrepreneur

Trait #1: Understands his finance requirements.

A responsible entrepreneur shall be clear about how much loan he requires, whether long term or short-term loan would work for him, how much security he can offer.

Trait #2: Understands which category his unit belongs to.

He is fully aware of responsible financing framework and knows which category (Green, Orange, Red, White) his unit belongs to. These categories are given by the state pollution board as per the pollution emission from the business activity.

He knows what the necessary compliances for his category are and conforms to them.

Trait #2: Has done comparative analyses of different loan offers.

He shall not just blindly accept any loan offer but would accept the one which will help him achieve maximum profits.

Trait #3: Has made a thorough analysis of costs associated with the finance.

After zeroing in on the loan offer, he will figure out how much the debt will cost him and whether the cash flows from his proposed project will be sufficient to pay off these costs.

Trait #4: Understands the social impact of his business activity

He shall adopt the best practices at his workplace to ensure his social responsibility. He will employ safe work environment for his workers, ensure gender equity, favorable working hours for employees, provide health and insurance benefits. He shall be ethical and treat his customers and suppliers fairly.

Trait #5: Understands the environmental impact of his business activity

He shall engage in the production of environment friendly products and services. He shall be aware of the carbon footprint of his business and would employ green practices like pollution control, sustainable purchasing, recycling, etc. to reduce it to the maximum extent possible.

Trait #6: Makes timely loan repayments.

Once availed, a responsible entrepreneur shall ensure to make his loan repayments on time to avoid any negative effect on his credit history.

Trait #7: Keeps a check on credit score and takes corrective measures if necessary.

He shall keep checking his credit score periodically and ensure there is no negative comment on the credit report.

Trait #8: Has employed sound financial management system

He shall employ a team of skilled staff to manage his finances and keep him financial statements up to date with regular checks and balances.

Trait #9: He shall be finance savvy.

Instead of leaving the financial management completely with his accounts team, he shall make himself aware of the key financial terms, learn the nitty gritty of financial management and how to ensure maximum profit in his business through best financial practices.

Trait #10: He shall ensure the value of his investments is realized.

He will work to his best ability to ensure every rupee invested in his business gives the desired profits so that he can do timely repayment of the debt.

Why is responsible financing great?

Responsible Financing talks about increased awareness about the social and environmental impact of your business and taking appropriate steps to check / mitigate any negative impact emanating out of it. It also means you have ensured that you comply with the social and regulatory norms

If you practice responsible financing, you are on a road to success. This is because you have all the traits necessary to derive the best out of your business through taking loans responsibly, maintaining your finances, working towards achieving maximum value from your investments. Further, with an increased sense of awareness towards the society and the environment, you ensure your contribution in the development of a better society and healthier environment.

Key Takeaways:

- *It is important to understand that success of MSMEs especially located in industrial clusters is in ensuring that they comply with the applicable environmental & social norms / guidelines.*
- *Any business / unit started by the entrepreneurs should be environment friendly (least impact on the environment) and should adopt latest energy efficient / green technology.*
- *It should not employ forced / child labour, should have proper mechanism in place to handle the waste with zero water discharge policy, should attempt to get ZED Certification from Quality Council of India (QCI).*
- *There are several examples (like Tirupur Textile Units wherein due to non-compliance to the Environmental regulatory compliances, the MSMEs had been shut down by National Green Tribunal (NGT) and/or the Pollution Control Boards (PSBs).*
- *Non-compliance / any violation of the pollution control board guidelines would also amount to criminal offence.*
- *NGT ensures that only such industries are allowed to operate, be it in the industrial clusters or elsewhere, which are in complete compliance with the applicable environmental & social regulations.*



Do interest rates only matter?

Businesses work with the inherent goal of profit generation. This is not only achieved by doing higher sales but also by reducing your cost of operations, finance costs, etc. Talking particularly about reducing finance costs, if you seek a business loan, naturally you would want the lowest interest rate so that you create assets at least costs and maximize your profits.

However, should interest rates be the only deciding factor for financing your investments? The answer is No.

Let's understand this with two examples:

I am Rakesh Kumar and I run a corrugated packaging unit. I have got big orders for supply of cardboard boxes from Amazon & Flipkart which I shall be unable to execute unless I acquire one more machine. Therefore, I contacted few banks (Bank X, Y & Z) for term loan

for repayment period of only 3 years. Bank X which charges 8% denied sanctioning the loan, Bank Y charges 8.5% but shall take about a month to sanction the loan whereas Bank Z which charges 8.75% agreed to sanction the machinery loan within 10 days. Considering the demand, I won't mind paying higher rate if I get timely funds for my business so that I can generate revenue and pay back the excess interest charged by Bank Z.

I am Dharmpal and I own a sweet shop. Due to upcoming festive season there is a lot of demand for sweets in the market, but I am falling short of funds for purchasing raw materials like milk, khoya, dry fruits, etc. Therefore, I approached few banks for working capital requirement. Bank X which charges 7% for working capital is agreeable to sanction WC but needs collateral against the loan which I don't possess; whereas Bank Y charging 8.0% is agreeable to sanction a collateral free loan under CGTMSE. Considering the huge demand and the profit prospect, I am comfortable in paying higher rate to meet urgent requirement of funds as I don't have any collateral to offer.

How to ensure best rates?

In the banking scenario which is prone to interest rate variations across the banks and as per the customers, it is crucial that we compare our options before choosing what's best for us. For doing this, we can take the help of portals such as *psbloansin59minutes*, which is a 100% digital portal. It provides you with the tools to check your loan eligibility, upload your documents, choose among the banks offering best rates of interest and get in-principle approval of your loan proposal within 59 minutes.
Portals like these empower us with appropriate, adequate and accessible credit. We need not to run here and there to decide on schemes, banks or interest rates. Instead, we can derive smart access benefits at one place on the click of a button.

Key Takeaways:

- *Interest rate cannot be the only factor in deciding your credit requirements.*
- *Timely and adequate funding is more crucial for making the decision.*
- *A loan with lower interest rate but which is delayed can prove more costly if you lose on the profit prospects of present investments.*

- *A loan which suits your requirements and is available at favorable terms when you need it can be preferred even if offering a higher rate of interest.*
- *Leverage digital platforms for getting the best offers.*
- *Every gain matters. Digital platforms also instill good governance.*



Payback analysis

Payback analysis is the methodology to calculate the payback period of an investment.

Suppose you make a business investment by buying a machinery. The purpose of this investment would be to generate profits for your business and has been funded by bank loan which you naturally need to repay. Bank loan will be your cost of investment which you will intend to pay with the profits generated by your machine. However, an investment (machinery in this case) will not generate immediate profits as we understood from the topic of Break-even analysis. Payback period is the time which this investment will take in recovering its cost. In simple terms, it calculates the time it takes for the investment to reach break-even.

Investments with shorter payback period will be more desirable as they will be able to cover their costs in a shorter time frame.

What do I need to do the payback analysis?

- You can use this analysis in knowing whether you will be able to pay back your cost of investment. In other terms, whether to go for a particular investment or not.
- You can also compare different investments by doing payback analysis on each of them.

How to calculate payback period?

Payback period = Amount of investment / Annual Cash Flow

Inflation and Purchasing Power

Inflation is the process in which prices of goods and services rise over time. If you receive money today, you can buy goods at today's prices. Presumably, inflation will cause the price of goods to rise in the future, which would lower the purchasing power of your money.

Money not spent today could be expected to lose value in the future by some implied annual rate, which could be inflation or the rate of return if the money was invested. The present value formula discounts the future value to today's money by factoring in the implied annual rate from either inflation or the rate of return that could be achieved if a sum was invested.

Key Takeaways:

- *Time value of money is based on the idea that people would rather have money today than in the future.*
- *Given that money can earn compound interest, it is more valuable in the present rather than the future.*
- *To gauge how quickly your new investment will be able to pay back its cost, you can do payback analysis.*
- *The payback period gives to the break-even point for your investment and can be useful in deciding on a particular investment or between different investments.*

- *The payback period refers to the amount of time it takes to recover the cost of an investment or how long it takes for an investor to reach breakeven.*
- *Account and fund managers use the payback period to determine whether to go through with an investment.*
- *Shorter paybacks mean more attractive investments, while longer payback periods are less desirable.*
- *The payback period is calculated by dividing the amount of the investment by the annual cash flow.*



Risk Management

Building a business takes work—and at the same time involves risks. If you are venturing into the field of entrepreneurship, risks are definitely a part of your portfolio and as a businessman, it's important not to fear them, but to know how to effectively manage them.

Here are a few risks that business can entail:

1) Economic Risk

Economy changes as the markets fluctuate. While positive changes may lead to booming of the economy, negative events like a pandemic can lead to an unexpected blow to the economy. This may lead to sudden drop in the market demand and hence reduce sales.

It's important to closely monitor changes and trends in the market to potentially identify and plan for an economic downturn.

How to manage economic risk?

Save as much money as possible to maintain a steady cash-flow. Also, operate with a lean budget with low overhead through all economic cycles as part of your business plan.

2) Compliance Risk

When you start a business and even when your business is up and running, you shall face several laws and regulations to comply with. For example, timely filing of GST returns, tax compliance etc. Failure to comply with these regulations/laws in due time can lead to punishments ranging from monetary penalties to imprisonment. This is called compliance risk.

How to manage compliance risk?

- Stay well versed in applicable laws from State and local agencies/bodies. A dedicated team for ensuring compliances can be set up.
- Do regular internal audit to keep a tab of your compliances.

3) Security and Fraud Risk

When you set up a company, there will be several personnel involved both inside and outside the organization who shall be involved with your business. While this eases your job, it also makes you susceptible to potential frauds like theft, impersonation, data

leakage, etc. Also, as more customers use online and mobile channels to share personal data, there are also greater opportunities for hacking. News stories about data breaches, identity theft and payment fraud illustrate how this type of risk is growing for businesses.

Not only does this risk impact trust and reputation, but an enterprise is also financially liable for any data breaches or fraud.

How to manage security and fraud Risk?

- Get a good understanding of the fraudsters mind by going through case studies of such attacks.
- Stay up to date with latest security systems that can be installed in your organization to improve the safety standards.
- Do a brainstorming session with your employees to identify their perception with the present risk management status in your company.
- Do regular assessments and audits of fraud vulnerability in the business.
- Take regular actions with the help of advisory team.

4) Financial Risk

This can be of several types:

(i) Risk of not being able to repay your business loans.
(ii) Risk of non-repayment by the customers.
(iii) Change in your creditor's loan collection policies.
(iv) Financial losses due to poor financial management policies

How to manage financial Risk?

- Proper business forecasting and management of business plan to avoid harming cash flow and deal with an unexpected loss.
- Keep debt to a minimum and create a plan that will start lowering that debt load as soon as possible.
- If you rely on all your income from one or two clients, your financial risk could be significant if one or both no longer use your services. Start marketing your

services to diversify your base so the loss of one won't devastate your bottom line.

5) Reputation Risk

There has always been the risk that an unhappy customer, product failure, negative press or lawsuit can adversely impact an enterprise's brand reputation. However, social media has amplified the speed and scope of reputation risk. Just one negative tweet or bad review can decrease your customer following and cause revenue to plummet.

How to manage reputation Risk?

- Regularly monitor what others are saying about the enterprise online and offline.
- Be ready to respond to those comments and help address any concerns immediately. Maintain quality of your products to avoid lawsuits and product failures that can also damage your enterprise's reputation.

6) Operational Risk

This business risk can happen internally, externally or involve a combination of factors. Something could unexpectedly happen that causes you to lose business continuity. That unexpected event could be a natural disaster or fire that damages or destroys your physical business. Or, it might involve a server outage caused by technical problems, people, or power cut. Many operational risks are also people related. An employee might make mistakes that cost time and money.

How to manage operational risk?

Whether it's a people or process failure, these operational risks can adversely impact your business in terms of money, time and reputation. Address each of these potential operational risks through training and a business continuity plan. Both tactics provide a way to think about what could go wrong and establish a backup system or proactive measures to ensure operations aren't affected.

Sensitivity Analysis

Sensitivity analysis is an investigation that is driven by data. Let's understand that by an example:

Sara runs a boutique and her sales are going pretty consistent for a while. However, there is no major growth in the business even though the demand in her industry is quite good. She decides to assess what she needs to change in order to increase her sales. She uses the 'what if' method and does her analysis:

- What if I change my interiors?
- What if I introduce a new design?
- What if I market my products more aggressively?
- What if I train my staff on customer satisfaction?
- What if I hire a celebrity to endorse my brand?

Now, with this analysis, she concludes that changing her interiors and hiring a celebrity may lead to significant costs and no drastic improvement in sales. However, introducing a new design, marketing her products and training of staff may amplify the sales to a good extent. She then decides to go for the latter.

This 'what-if' analysis is also called sensitivity analysis. It examines how changing of the input variables affect the target variables. It helps us understand the effect of a business decision based on a group of variables and hence is used to evaluate the overall risk, do business forecasting and decision making.

How to interpret sensitivity analysis

The interpretation of the sensitivity analysis can be done by keeping the following factors in mind:

a) Create experimental design

It is important to create an experimental design of the business model and find what parameters can affect it the most. By assigning different values to different variables ranging from minimum to maximum, one can know the immediate and

long-term effect of various parameters on business. Find the best suitable combination and apply it in the business model.

b) What are the parameters?

To correctly interpret the results, the parameters selected should be right. The parameters can be different for different models of business. However, the common parameters may include technical parameters, number of activities involved in business, number of bottlenecks, risk, and effect of bottlenecks on business, etc.

c) Observe

Observation is important as it determines which strategy must be followed by the business for higher growth and profit maximization. The observation may involve the outcome of analysis based on different decision variables, the impact of different variables and parameters on the strategy of the business, any ratifications to be made in the strategy, etc.

Methods of sensitivity analysis

There are two methods for carrying the analysis. They are as follows.

a) Simulation and modeling technique

Simulate a range of scenarios and see their outcomes as in our example.

b) Scenario management using MS Excel

Scenario Manager in Microsoft Excel is an excellent tool for conducting sensitivity analysis. Using this tool, one can easily define various scenarios and see their respective results.

Key Takeaways:

- *Risk is inevitable with the business. We can't remove it completely but can definitely take steps to mitigate it.*
- *Good risk management practices ensure that you are ready to deal with any unforeseen circumstances in the business.*
- *Using sensitivity analysis, you can understand the impact of different business decisions to your profitability. This helps you to forecast future results and choose the best option.*
- *It is a good practice to have a dedicated staff looking at the risk management aspect of your business.*
- *You can take the help of several softwares and tools available to perform sensitivity analysis.*
- *Take conscious risks. It will ensure your brisk entrepreneurial walk.*



Failure Cause Analysis

A wise businessman is one who learns from his mistakes, but a smart businessman learns not only from his own, but also from his peers' mistakes and takes precautionary measures so that he does not repeat them. In this chapter, we are addressing this smart businessman and presenting some case studies of companies which turned Non-Performing Assets (NPAs). We shall analyse the causes which led to these situations so that our smart businessman learns from them and stays ahead of the herd.

Name of the unit / Masked	Category / Risk category	Brief highlights on the key factors/ causes
ABC Pvt. Ltd.	Policy Change/ Market Risk	➢ Usage/ manufacture of plastics below certain configuration/ guidelines issued by various environmental bodies had been banned. This was done to regulate

		construction in ecologically sensitive areas like bird sanctuaries etc. ➢ These restrictions resulted in hampering construction and delay in implementation of the project. ➢ This led to severe liquidity crunch in the unit resulting in account turning NPA.
DEF Pvt. Ltd.	Power related problems/ Business Risk	➢ Location of unit was in remote area where no industrial lines were available and industrial feeder was around 15 Km away. ➢ Due to hefty cost involved, borrower delayed the connection and ran the factory on DG set, which resulted in very high cost of production. ➢ This adversely impacted the profitability and liquidity position. ➢ Also, in one of the cases, due to power related issues, the unit could be run on single shift only. This negatively impacted its profitability.
GHI Pvt. Ltd.	Lack of adequate working capital/ Business Risk	➢ Liquidity Issues due to prolonged receivable days, excess Investment in the capital expenditure by the company and slowdown in the industry resulted in hampering the business operations. ➢ The Working Capital banker could not increase the limit due to security constraints.
JKL Pvt. Ltd.	Recession in the industry/ Industry Risk	➢ The borrower was engaged in manufacturing of automobile

		components for various customers located in India as well as abroad. ➢ Due to slowdown in the auto industry, there was an adverse impact on the overall sales and the order book position. ➢ This resulted in poor performance of the unit.
MNO Pvt. Ltd.	Conflict among promoters / Management Risk	➢ In some cases, the Executive Director's/ Key Managerial Personnel/ Promoter shifted base abroad, which resulted in lack of cohesiveness and decision making in the business. ➢ This led to failure of the business operations.
MNO Pvt. Ltd.	Red Category Unit /Non-obtention of Consent to Establish permission from State Pollution Control Board/ Statutory Compliance Risk	➢ A Red category unit did not obtain Consent to Establish permission from State Pollution Control Board (SPCB) and sought repeated relaxations for extension of time. ➢ Ultimately, the permission was denied by SPCB and the project got stalled which led to the account slipped into NPA category.
PQR Pvt. Ltd.	Labour related issue Management Risk	➢ The Company faced labour conflicts and the management could not resolve the issue. ➢ This led to temporary closure of the factory and the slippage of account to NPA category

Key Takeaways:

- *An account can turn into an NPA due to mis management inside the business as well as due to factors out of the business's control, like macroeconomic situations.*
- *It is a good practice to keep an eye on the internal as well as external factors and take corrective measures, whenever necessary.*
- *Stay in touch with the banker and inform him of any ongoing issues with the business so that a resolution plan can be made in time.*
- *Ensure sound financial management in your business and keep track of your cash flows.*
- *Keep tab of the government policies in your field as well as your industry and be ready to adapt whenever some changes are introduced.*

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