**Unit 3. Financial Plans**

**Financial planning** is the task of determining how a business will afford to achieve its strategic goals and objectives. Usually, a company creates a Financial Plan immediately after the vision and objectives have been set. The Financial Plan describes each of the activities, resources, equipment and materials that are needed to achieve these objectives, as well as the time frames involved.

The Financial Planning activity involves the following tasks:

* Assess the business environment
* Confirm the business vision and objectives
* Identify the types of resources needed to achieve these objectives
* Quantify the amount of resource (labor, equipment, materials)
* Calculate the total cost of each type of resource
* Summarize the costs to create a budget
* Identify any risks and issues with the budget set.
* (Recognise and identify potential resources to meet the financial requirements?)

Performing Financial Planning is critical to the success of any organization. It provides the Business Plan with rigor, by confirming that the objectives set are achievable from a financial point of view. It also helps the CEO to set financial targets for the organization, and reward staff for meeting objectives within the budget set.

When drafting a financial plan, the company should establish the planning horizon, which is the time period of the plan, whether it be on a short-term (usually 12 months) or long-term (2–5 years) basis. Also, the individual projects and investment proposals of each operational unit within the company should be totaled and treated as one large project. This process is called aggregation.

The purpose of a financial plan is to show the financial impact of a company's strategic and operating plans for the next 12 months, and over a longer period of three to five years. Financial plans guide management decisions. They should be flexible enough to accommodate changes in business and economic conditions. Financial plans also provide venture capitalists, investors and creditors with the information they need to assess a company's current and future financial prospects. The components of a financial plan include a pro forma income statement, balance sheet and cash flow statement. The income statement contains sales and expense projections, the balance sheet includes projections of assets and liabilities, and the cash flow statement or budget shows the cash inflows and outflows. Financial plans may also include a break-even analysis, which shows the sales volumes and prices at which a company covers its costs and starts to make money. Management should compare actual results with projections to determine if any changes are necessary.

Balance sheet

You can visualize a balance sheet as a two column page, on the left side you have your assets and on the right side you have your liabilities.

You can further define your assets as “liquid” assets, these are assets that are available on a short notice such as savings accounts, and short term investments. You can also have “non-liquid” assets, these are assets that are not readily available, such as your house and other property.

You can do a similar thing for your liabilities, you can also mark your liabilities as “fixed” or “variable” depending on what type of liability it is and short-term vs long-term.

Net worth

Your net worth is simple to calculate. Once you have all your assets and liabilities organized you simply subtract assets from liabilities and that is your net worth (Asset-liabilities=Net worth). This is basically what you will have if you would sale all your assets and payoff your liabilities. Can this be negative? YES, it can. In fact way too many people have a negative net worth in North America. For some due to high amount of student loan, although their education is a (intangible)definite asset which unfortunately cannot be given a value.

Having a balance sheet gives a clear picture of your financial strength. Usually when you apply for loans, the lenders will want to know your net worth. This will tell how strong your financial position is and how you can handle potential financial problems. You should take a look at your balance sheet at least every quarter to help you keep track of your progress.

The balance sheet is an indispensable tool for businesses of all sizes. At a glance, the balance sheet provides a snapshot of the company's financial health. Arguably, the balance sheet is the most important of the three major financial statements, the other two being the income and cash flow statements. Learning how to read a balance sheet is the first essential step for any business owner.

## Assets vs Liabilities

A balance sheet details what a business owns and compares it to what it owes. The difference between the two makes up the shareholder equity. Assets are listed on one side of the balance sheet, while the other side lists liabilities and shareholder equity. The sum of assets equals the sum of liabilities plus shareholder equity. This is because what the company owns, in other words assets, must always be equal to the total claims on those assets. Creditors, as well as shareholders, have a claim on assets. This basic equation allows you to assess at a glance how the shareholder funds invested in the business have grown or diminished.

## Financial Condition

By comparing assets to liabilities listed on the balance sheet, managers as well as outsiders, such as investors and suppliers, can assess whether the business will have a hard time paying its bills. Assets, such as cash, stocks, bonds, and any liquid holdings that can easily be turned into cash, should ideally be higher than upcoming payment obligations. If the business has more upcoming liabilities than assets that can be turned into cash quickly, it might have a hard time paying its loans. Balance sheets typically separate payment obligations due in less than one year from longer-term debt to make this analysis easier.

## Asset Breakdown

The balance sheet also provides a detailed breakdown of the kinds of assets the business owns. The balance sheet of a furniture manufacturer, for example, will detail the amount of raw materials, such as wood and paint; the amount of work-in-progress, which is semi-finished furniture; and the amount of finished goods in the warehouse. This information helps to understand how much cash can be realized by selling the finished goods and how much time, effort and money must be invested to turn the raw materials and semi-finished goods into potentially cash-generating items. This helps the managers match resources and obligations.

## Scenario Analysis

The basic balance sheet equation, which stipulates that assets must equal liabilities plus shareholder equity, allows an analyst to play with numbers on either side to assess the potential impact of various possible outcomes on the business. For example, the impact of running a sale to liquidate inventory at only a slight profit can easily be evaluated if you know the basic workings of a balance sheet. In most cases, the analyst will obtain a more complete picture by also checking the income statement and cash flow statement. A basic course in accounting, covering the workings of all three financial statements, is therefore a must for anyone involved in business.

**Pro-forma income statement** is an income statement which is prepared as a projection of the future as opposed to the actual transactions of the past. In other words, an income statement projects, the financial performance of the period that has already expired (past) whereas pro forma income statement is prepared to project the expected financial performance of the future.

Generally, pro-forma income statement is prepared with the current and past data in mind and adjusted to reflect any possible future event as a guide to project the future performance of an enterprise. These statements are prepared based on assumptions about the future and are to that extent vulnerable to changes and inaccuracies.

There are several benefits obtained out of pro-forma income statements.

\* They are an important tool for planning future operations of the enterprise.

\* They act as a benchmark for business operations and direct the resources and efforts of an enterprise towards the objectives set by the statement.

\* Corrective and preventive actions can be taken based on the pro-forma income statements that predict a difficult situation in the future and help the business gear-up to the challenges that are anticipated ahead.

The major drawback is the fact that they are mere projections of the future which is uncertain. The basis of preparation of pro-forma statements viz. the past data and assumptions play a very important role. An incorrect or wrong assumption may lead the enterprise to focus attention and resources in areas that may eventually prove harmful to the enterprise. Past data may also not always be an indication of future performance especially in cases where there are significant changes in the environment in which the business operates.

Nevertheless, pro-forma income statement is an important document for businesses to plan and organize their efforts in the direction of intention reflected in there.

## Cash Flow Budget

The purpose of a cash flow budget is to show the cash inflows and outflows, usually on a monthly basis and for the next 12-month period. **Pro forma cash flow budgets** usually have three sections for operating, investing and financing activities. Management can use a cash flow budget to identify and plan for potential cash shortfalls. Planning may include reducing expenditures and arranging a line of credit to fill temporary cash needs. Companies should use realistic ratios for projecting collections on outstanding invoices. Established companies can use their historical results, while new companies can make projections based on industry averages. Changes in business and economic conditions can affect cash flow. For example, if a company usually collects 80 percent of its invoices within 30 days and economic conditions are worsening, it should use a lower collection ratio for its cash flow budget. Management should review differences between actual and projected cash flows at the end of each month and make the necessary adjustments to the budget for the remainder of the year.

Pro forma cash flow is the estimated amount of cash inflows and outflows expected in one or more future periods. This information may be developed as part of the annual budgeting or forecasting process, or it may be created as part of a specific request for cash flow information, as may be required by a prospective lender or investor.

Pro forma cash flow information is useful for estimating when there may be cash shortages in the near future, so that management can prepare by obtaining additional debt or equity funding to offset the projected shortfall. Another alternative is to plan for expenditure reductions in order to avoid future cash usage. If excess cash is projected by the pro forma document, this information can also be used to plan the most appropriate investment strategy for the cash.

Pro forma cash flow is arguably the most essential of the various pro forma documents, which can also include the income statement and [balance sheet](https://www.accountingtools.com/articles/2017/5/17/the-balance-sheet), since the other documents are rendered invalid if an inadequate amount of cash is projected to be available to support management's plans.

A pro forma cash flow is constructed using several methods, each covering a different period of time. The methods pertaining to the forecasting periods are:

* Short term - Expected cash receipts from outstanding invoices and cash payments for existing accounts payable are used to derive cash flows for the next few weeks. This forecast should be very accurate.
* Medium term - Revenues that have not yet been billed are estimated from the order backlog and translated into cash receipts for the next few months. The expenses required to support the revenue noted in the order backlog are translated into cash payments for the same period of time.
* Long term - Budgeted revenues and expenses are translated into cash receipts and payments, respectively. This information may not be very accurate at all.

The information used in the pro forma cash flow document can also be impacted by the estimated days sales outstanding for receivables from customers, as well as the estimated days to pay suppliers. These figures should not vary much from historical averages, or else it is likely that the pro forma results will not be attainable.

The pro forma document tends to be fairly accurate for the first few weeks of the projection, and then declines rapidly in accuracy over succeeding periods. To improve the reliability of the document, it should be updated at regular intervals with the most recent information. Also, the document is more likely to be accurate if the company has a stable order backlog, and much less accurate if there is little insight into the sources of short-term sales.

Even if a pro forma cash flow proves to be relatively unreliable, it at least forces management to think about expected future cash flows, which may contribute to its caution in ensuring that the business has sufficient cash on hand to fund operations.

**There are 3 basic financial statements that exist in the area of Financial Management.**

1. Balance Sheet.

2. Income Statement.

3. Cash Flow Statement and Fund Flow Statement

The first two statements measure one aspect of performance of the business over a period of time. *Cash flow statements signify the changes in the cash and cash equivalents of the business due to the business operations in one time period*. *Funds flow statements report changes in a business's working capital from its operations in a single time period, but have largely been superseded by cash flow statements.*

A **Cash Flow** **Statement** is a statement showing changes in cash position of the firm from one period to another. It explains the inflows (receipts) and outflows (disbursements) of cash over a period of time. The inflows of cash may occur from sale of goods, sale of assets, receipts from debtors, interest, dividend, rent, issue of new shares and debentures, raising of loans, short-term borrowing, etc. The cash outflows may occur on account of purchase of goods, purchase of assets, payment of loans loss on operations, payment of tax and dividend, etc.

A cash flow statement is different from a cash budget. A cash flow statement shows the cash inflows and outflows which have already taken place during a past time period. On the other hand a cash budget shows cash inflows and outflows which are expected to take place during a future time period. In other words, *a cash budget is a projected cash flow statement*.

**Funds Flow** **Statement** states the changes in the working capital of the business in relation to the operations in one time period.

The main components of Working Capital are:

Current Assets

1. Cash

2. Receivables

3. Inventory

Current Liabilities

1. Payables

Net working capital is the total change in the business's working capital, calculated as total change in current assets minus total change in current liabilities.



EXAMPLE**:** If the inventory of the business increased from Rs 1,40,000 to Rs 1,60,000, then this increase of Rs 20,000 is the increase in the working capital for the corresponding period and will be mentioned on the funds flow statement. But the same would not be reflected in the cash flow statement as it does not involve cash.

So the Fund Flow Statement uses all the above four components and shows the change in them. While a cash flow statement only shows the change in cash position of the business.

Cash flow statements have largely superseded funds flow statements as measurements of a business's liquidity because cash and cash equivalents are more liquid than all other current assets included in working capital's calculation.

What is Included in a Cash Flow Statement?

The statement of cash flows uses information from the other two statements (Income Statement and Balance Sheet) to indicate cash inflows and outflows.

A Cash Flow Statement comprises information on following 3 activities:

*1.* *Operating Activities*

*2.* *Investing Activities*

*3.* *Financing Activities*

**1. Operating Activities:** Operating activities include cash flows from all standard business operations. Cash receipts from selling goods and services represent the inflows. The revenues from interest and dividends are also included here. The operational expenditures are considered as outflows for this section. Although interest expenses fall under this section but the dividends are not included .Dividends are considered as a part of financing activity in financial accounting terms.

**2. Investing Activities:** Investing activities include transactions with assets, marketable securities and credit instruments. The sale of property, plant and equipment or marketable securities is a cash inflow. Purchasing property, plant and equipment or marketable securities are considered as cash outflows. Loans made to borrowers for long-term use is another cash outflow. Collections from these loans, however, are cash inflows.

**3. Financing Activities:** Financing activities on the statement of cash flows are much more defined in nature. The receipts come from borrowing money or issuing stock. The outflows occur when a company repays loans, purchases treasury stock or pays dividends to stockholders. As the case with other activities on the statement of cash flows depend on activities rather than actual general ledger accounts.

Table of Difference between Funds Flow Statement and Cash Flow Statement

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| --- | --- | --- | --- |
|  | Basis of Difference | Funds Flow Statement | Cash Flow Statement |
| 1. | Basis of Analysis | Funds flow statement is based on broader concept i.e. working capital. | Cash flow statement is based on narrow concept i.e. cash, which is only one of the elements of working capital. |
| 2. | Source | Funds flow statement tells about the various sources from where the funds generated with various uses to which they are put. | Cash flow statement stars with the opening balance of cash and reaches to the closing balance of cash by proceeding through sources and uses. |
| 3. | Usage | Funds flow statement is more useful in assessing the long-range financial strategy. | Cash flow statement is useful in understanding the short-term phenomena affecting the liquidity of the business. |
| 4. | Schedule of Changes in Working Capital | In funds flow statement changes in current assets and current liabilities are shown through the schedule of changes in working capital. | In cash flow statement changes in current assets and current liabilities are shown in the cash flow statement itself. |
| 5. | End Result | Funds flow statement shows the causes of changes in net working capital. | Cash flow statement shows the causes the changes in cash. |
| 6. | Principal of Accounting | Funds flow statement is in alignment with the accrual basis of accounting. | In cash flow statement data obtained on accrual basis are converted into cash basis. |

**Advantages of Cash Flow Statement**

1. It shows the actual cash position available with the company between the two balance sheet dates which funds flow and profit and loss account are unable to show. So it is important to make a cash flow report if one wants to know about the liquidity position of the company.

2. It helps the company in accurately projecting the future liquidity position of the company enabling it arrange for any shortfall in money by arranging finance in advance and if there is excess than it can help the company in earning extra return by deploying excess funds.

3. It acts like a filter and is used by many analyst and investors to judge whether company has prepared the financial statements properly or not because if there is any discrepancy in the cash position as shown by balance sheet and the cash flow statement, it means that statements are incorrect.

Disadvantages of Cash Flow Statement

1. Since it shows only cash position, it is not possible to deduce actual profit and loss of the company by just looking at this statement.

2. In isolation this is of no use and it requires other financial statements like balance sheet, profit and loss etc…, and therefore limiting its use.

Advantages of Fund Flow Statements

A Funds flow statement is prepared to show changes in the assets, liabilities and equity between two balance sheet dates, it is also called statement of sources and uses of funds. The advantages of such a financial statement are many fold.

Some of these are:

1. Funds flow statement reveals the net result of Business operations done by the company during the year.

2. In addition to the balance sheet, it serves as an additional reference for many interested parties like analysts, creditors, suppliers, government to look into financial position of the company.

3. The Fund Flow Statement shows how the funds were raised from various sources and also how those funds were deployed by a company, therefore it is a great tool for management when it wants to know about where and from what sources funds were raised and also how those funds got utilized into the business.

4. It reveals the causes for the changes in liabilities and assets between the two balance sheet dates therefore providing a detailed analysis of the balance sheet of the company.

5. Funds flow statement helps the management in deciding its future course of plans and also it acts as a control tool for the management.

6. Funds flow statement should not be looked alone rather it should be used along with balance sheet in order judge the financial position of the company in a better way.

Disadvantages of Fund Flow Statements

Funds flow statement has many advantages; however it has some disadvantages or limitations also.

Let’s look at some of the limitations of funds flow statement.

1. Funds Flow statement has to be used along with balance sheet and profit and loss account for inference of financial strengths and weakness of a company it cannot be used alone.

2. Fund Flow Statement does not reveal the cash position of the company, and that is why company has to prepare cash flow statement in addition to funds flow statement.

3. Funds flow statement only rearranges the data which is there in the books of account and therefore it lacks originality. In simple words it presents the data in the financial statements in systematic way and therefore many companies tend to avoid preparing funds flow statements.

4. Funds flow statement is basically historic in nature, that is it indicates what happened in the past and it does not communicate anything about the future, only estimates can be made based on the past data and therefore it cannot be used the management for taking decision related to future.

We can conclude that shorter the planning period more relevant is the “Cash Flow Statement and longer the planning period more relevant is the “Fund Flow Statement”

**Meaning of Ratio Analysis**

Ratios are a comparison of two numbers with respect to each other. Similarly, in finance, ratios are a correlation between two numbers, or rather two accounts. So two numbers derived from the financial statement are compared to give us a more clear understanding of them. This is an accounting ratio.

Let us take an example. The income for the year from operations is let us say 1,00,000/- for a given year. The Purchases and other direct expenses cost around 75,000/-. So the Gross Profit f the year is 25,000/-. Now it can be said that the Gross Profit is 25% of the Operations Revenue. We calculate this as

G.P. Ratio = *G**P**S**a**l**e**s*/*R**e**v**e**n**u**e* ×100

G.P.Ratio = 25,0001,00,000 ×100

G.P. Ratio = 25%

One factor to be kept in mind is that ratio analysis is used only to compare numbers that make sense and give us a better understanding of the financial statement. Comparing random financial accounts should be avoided. Interpreting the financial statements and other financial data is essential for all stakeholders of an entity. Ratio Analysis hence becomes a vital tool for financial analysis and financial management.

### Objectives of ratio analysis

### 1] Measure of Profitability

Profit is the ultimate aim of every organization. So if I say that ABC firm earned a profit of 5 lakhs last year, how will you determine if that is a good or bad figure? Context is required to measure profitability, which is provided by ratio analysis. Gross Profit Ratios, Net Profit Ratio, Expense ratio etc provide a measure of profitability of a firm. The management can use such ratios to find out problem areas and improve upon them.

### 2] Evaluation of Operational Efficiency

Certain ratios highlight the degree of efficiency of a company in the management of its assets and other resources. It is important that assets and financial resources be allocated and used efficiently to avoid unnecessary expenses. Turnover Ratios and Efficiency Ratios will point out any mismanagement of assets.

### 3] Ensure Suitable Liquidity

Every firm has to ensure that some of its assets are liquid, in case it requires cash immediately. So the liquidity of a firm is measured by ratios such as Current ratio and Quick Ratio. These help a firm maintain the required level of short-term solvency.

### 4] Overall Financial Strength

There are some ratios that help determine the firm’s long-term solvency. They help determine if there is a strain on the assets of a firm or if the firm is over-leveraged. The management will need to quickly rectify the situation to avoid liquidation in the future. Examples of such ratios are Debt-Equity Ratio, Leverage ratios etc.

### 5] Comparison

The organizations’ ratios must be compared to the industry standards to get a better understanding of its financial health and fiscal position. The management can take corrective action if the standards of the market are not met by the company. The ratios can also be compared to the previous years’ ratio’s to see the progress of the company. This is known as trend analysis.

## Advantages of Ratio Analysis

When employed correctly, ratio analysis throws light on many problems of the firm and also highlights some positives. Ratios are essentially whistleblowers, they draw the managements attention towards issues needing attention. Let us take a look at some advantages of ratio analysis.

* Ratio analysis will help validate or disprove the financing, investment and operating decisions of the firm. They summarize the financial statement into comparative figures, thus helping the management to compare and evaluate the financial position of the firm and the results of their decisions.
* It simplifies complex accounting statements and financial data into simple ratios of operating efficiency, financial efficiency, solvency, long-term positions etc.
* Ratio analysis help identify problem areas and bring the attention of the management to such areas. Some of the information is lost in the complex accounting statements, and ratios will help pinpoint such problems.
* Allows the company to conduct comparisons with other firms, industry standards, intra-firm comparisons etc. This will help the organization better understand its fiscal position in the economy.

## Limitations of Ratio Analysis

While ratios are very important tools of financial analysis, they d have some limitations, such as

* The firm can make some year-end changes to their financial statements, to improve their ratios. Then the ratios end up being nothing but window dressing.
* Ratios ignore the price level changes due to inflation. Many ratios are calculated using historical costs, and they overlook the changes in price level between the periods. This does not reflect the correct financial situation.
* Accounting ratios completely ignore the qualitative aspects of the firm. They only take into consideration the monetary aspects (quantitative)
* There are no standard definitions of the ratios. So firms may be using different formulas for the ratios. One such example is Current Ratio, where some firms take into consideration all current liabilities but others ignore bank overdrafts from current liabilities while calculating current ratio
* And finally, accounting ratios do not resolve any financial problems of the company. They are a means to the end, not the actual solution.

**Break-even analysis**

The break-even analysis lets you determine what you need to sell, monthly or annually, to cover your costs of doing business—your break-even point.

The break-even analysis table calculates a break-even point based on fixed costs, variable costs per unit of sales, and revenue per unit of sales.

The break-even analysis depends on three key assumptions:

### 1. Average per-unit sales price (per-unit revenue):

This is the price that you receive per unit of sales. Take into account sales discounts and special offers. Get this number from your sales forecast.

For non-unit based businesses, make the per-unit revenue one dollar and enter your costs as a percent of a dollar. The most common questions about this input relate to averaging many different products into a single estimate.

The analysis requires a single number, and if you build your sales forecast first, then you will have this number. You are not alone in this, the vast majority of businesses sell more than one item, and have to average for their break-even analysis.

### 2. Average per-unit cost:

This is the incremental cost, or variable cost, of each unit of sales. If you buy goods for resale, this is what you paid, on average, for the goods you sell. If you sell a service, this is what it costs you, per dollar of revenue or unit of service delivered, to deliver that service.

If you are using a units-based sales forecast table (for manufacturing and mixed business types), you can project unit costs from the sales forecast table. If you are using the basic sales forecast table for retail, service and distribution businesses, use a percentage estimate, e.g., a retail store running a 50 percent margin would have a per-unit cost of .5, and a per-unit revenue of 1.

### 3. Monthly fixed costs:

Technically, a break-even analysis defines fixed costs as costs that would continue even if you went broke. Instead, it is recommended that you use your regular running fixed costs, including payroll and normal expenses (total monthly operating expenses). This will give a better insight on financial realities.

If averaging and estimating is difficult, one should use profit and loss table to calculate a working fixed cost estimate—it will be a rough estimate, but it will provide a useful input for a conservative break-even analysis.

The break-even analysis depends on assumptions made for average per-unit revenue, average per-unit cost, and fixed costs. These are rarely exact.