FINANCIAL PLANNING

Lecture 1
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Plekhanov Russian University of Economics
References and Relevant websites


References and Relevant websites


Preface

• Due to the globalization of business activities and the internationalization of the capital markets,

• demands on internal and external company reporting have increased, primarily the reporting of future chances and risks has taken an outstanding position in this context.
Problems of the realization

• The FINANCIAL PNANNING is a universal means.

• **Big companies** have more or less large staff divisions which have the task of thinking about strategic questions and their orientation in order to **work out the plans for the next years**.

• **Mid-size or small companies** cannot afford their own staff divisions or planning departments to compile and plan their strategy. In such a case it is the manager’s or entrepreneur’s task to develop a strategy, to define future plan data and to implement them.

• Many mid-size or small companies **fail**, because they recognize market developments **too late**, because they do not promote the **right products**, because they have not thought about certain **technological processes**, because they have **not adapted** their organization in time.
investment

How are concepts connected with FINANCIAL PLANNING?

inflation

unemployment
How are concepts connected with FINANCIAL PLANNING?

| investment | inflation | unemployment |

Rate of Inflation Formula:

\[
\text{Rate of Inflation} = \frac{(CPI_{x+1} - CPI_x)}{CPI_x}
\]
Investment       COMPARE        Consumption

To invest         To save

Next consumption  

Portfolio theory  

Assets           Liabilities

Expenses         Liquidity         Ability to pay
Investment manager  COMPARE  Financial manager

**Equity / borrowed capital – COST of capital**

- Higher price
- Lower cost of capital

**Present / future value**

- Lower price
- Higher rate of the return on the capital

**Income/ profit**

**Risk**

**Increase valuation of the company**
FINANCIAL PLANNING

The objective

To get profit

Shareholders

Dividend payment

Government

Tax payment

The firm itself

Retained earnings
COMPARE:

- **equity**
- **borrowed capital**
- **risk**

**SURPLUS**

- Economic value added

**SHORTAGE**

- Economic value added

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**Growing Your Firm**
FINANCIAL PLANNING PROCESS

Client Focused

Establish parameters
- Conduct cash flow analysis
- Develop investment policy statement
- Design strategic and tactical asset allocation models

Evaluate & Review
- Assess macro- and microeconomic trends and outlook for global capital markets

Analyze & Plan
- Conduct rigorous due diligence using industry analytics

Assess & Construct

Design & Research
Business Needs

Research and define the specific ways in which this new product must generate business success

Customer Needs

Research and define what new solutions would increase customer retention, expansion and advocacy

Market Needs

Research and define the solutions and characteristics the market is likely to respond positively to

Competitor Products

Research and define how competitors are addressing business/market/customer needs
Key steps to draw up a basic financial plan:

1. Assess your financial situation
2. Create a budget
3. Set your financial goals
4. Know your risk tolerance
5. Work out and implement a basic financial plan
6. Regularly review and adjust your financial plan
Step 1. Evaluate your financial situation

With a clear understanding of your current financial situation, you can decide where you should start from, and what you need to achieve your financial goals.

Knowing a net worth is important to assessing your financial situation.
Step 2. Create a budget

• Create a budget using 0-based principle
• Make it a habit to save part of the income every month. The earlier the firm starts saving, the better chance it has to realise its financial goals.
• Set aside money for paying tax.
• Maintain a good credit rating by making all loan and debt payments on time.
• Review insurance coverage to ensure it meets the firm’s needs.
• Set some short-term goals and one long-term goal for different
Assets / Liabilities
### Step 3. Set financial goals

<table>
<thead>
<tr>
<th>Proper Mobilization of Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proper Utilization of Funds</td>
</tr>
<tr>
<td>Earning more Profits</td>
</tr>
<tr>
<td>Maintaining Liquidity</td>
</tr>
<tr>
<td>Maximizing Shareholders Wealth</td>
</tr>
<tr>
<td>Reserves</td>
</tr>
<tr>
<td>Increase in Overall Efficiency</td>
</tr>
<tr>
<td>Generates Goodwill</td>
</tr>
</tbody>
</table>
Step 4. Evaluate risk tolerance

<table>
<thead>
<tr>
<th>Risk Tolerance</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative</td>
<td>Not willing to take up risk and see loss in investment and may rather forgo potential gains.</td>
</tr>
<tr>
<td>Moderately cautious</td>
<td>May be willing to accept a limited amount of risks to improve their long-term investment returns, but still try to avoid large short-term fluctuations.</td>
</tr>
<tr>
<td>Balanced</td>
<td>Weighting the risks and returns, balanced investors recognise that taking on a measured amount of risks will improve the probability of achieving their long-term financial goals.</td>
</tr>
<tr>
<td>Moderately aggressive</td>
<td>By taking on greater investment risks, moderately aggressive investors expect to see their investment portfolio outperform the market; and do not mind accepting a bit more risk or loss than the market bears.</td>
</tr>
<tr>
<td>Aggressive</td>
<td>Ready to take on higher levels of risks in order to substantially outperform the markets.</td>
</tr>
</tbody>
</table>
Step 5. Work out and implement a basic financial plan

**Future consumption**
These expenses may deplete assets and can be long-term financial commitments.

**Insurance**
Unexpected incidents can deplete savings and erode assets. Having **adequate** insurance coverage for these eventualities should be a key component of financial planning.

**Estate planning**
It is an essential part of long-term financial planning.

**Responsible borrowing**
Past credit record may also affect the cost of borrowing in the future.
Step 6. Regularly review and adjust financial plan

- Consider both risk and return
- Understand your risk tolerance
- Keep an eye on your liquidity
- The higher the needs for ready cash, the more it should be kept as liquid assets.
- How strong are your financial resources?
Necessity of planning
A business plan

A business plan – a document that commercializes the business idea as a whole towards potential investors and stakeholders.

A business plan should justify and describe the business idea and further business development in a clear and adequate manner, describing this company realistically.

It should not merely aim at emphasizing the strengths of the company, but rather at presenting a realistic portrait of its problems, risks and obstacles.
Three important features of a successful business plan

• The short- and long-term objectives are clearly depicted,

• A careful description is given of how the objectives can be achieved in realistic general conditions and

• A description is given of how the realization of the plan will meet the expectations of the investors.
External use of a planning document

From an external point of view the financial plan represents the main financing tool of your company.
External use of a planning document

1. The investors are primarily interested in good and relevant arguments that promise business growth.

2. Investors attach great importance to how and in which period of time a return on investment will be realized, for instance:
   • through operating profit or
   • by going public or
   • by merger and acquisition or
   • through a repurchase by the management.

3. In order to guarantee a high return on investment, investors pay great attention to:
   • the company’s success on the market,
   • the feasibility of the plan in order to achieve its business objectives,
   • the unique selling proposition of the products and services and
   • the quality and experience of the management team.
Internal use of a planning document

A financial plan also serves as a valuable management tool from an internal viewpoint of the company.

A systematically elaborated and regularly updated financial plan, with a profound insight into all business matters, helps the management to efficiently plan the company’s development and prepare the necessary modification measures in a structured way.

Such a financial plan can serve as a guide to the daily decision-making and as a control tool in managing the current business.

Financial plans make a significant contribution to the development of companies which have branches in different locations.
Basic types of financial plans

How detailed your financial plan should be depends on the purpose and necessity behind it.

In general, one distinguishes between three basic types of plans:

• the short financial plan,

• the extended financial plan and

• the operational financial plan.
Short financial plan

• A short financial plan is usually about 10 to 15 pages long.

• It is most suitable for young companies in an early stage of their development when, there still do not exist complex interrelations.

• For a well-established company, a short business plan only makes sense if certain investment opportunities are to be roughly approved in advance, in order to prepare an extended business plan on the base of the short version later on.
Extended financial plan

• The extended financial plan is usually about 20 to 40 pages long.

• This type of financial plan describes the business issues of the company much more profoundly and more detailed than a short business plan would do.

• The higher the required capital, the more detailed this type of financial plan becomes.

• Such a financial plan should contain a thorough market analysis and a revenue, cost and financial planning for a 5-year period.
Operational financial plan

• For well-established companies a financial plan can serve the management team as an important operative tool, say a business guideline.

• Such a plan not only serves as a draft for the entire business organization, but also ensures a consistent appreciation on the part of the entire management with respect to the strategic objectives.

• Indeed, operational financial plans are very long and detailed, usually comprising over 40 pages, in some cases even exceeding 100 pages.
Key questions

• What goals are you pursuing with your financial plan?

• What purpose should your financial plan serve?
  – Preparation for negotiations with banks
  – Presentation for investors
  – As an internal management tool

• Which target groups and people do you want to approach by means of your financial plan?

• What expectations, needs and demands do your readers have?

• Which type of financial plan will you choose and why?
Business plan project
Business plan project: structure

Business plans vary in their structure and content, they all have some features in common:

• they propose and describe business models,
• products or services,
• describe their corresponding markets,
• ways of production
• and service delivery.
Phases of the business plan project

- Data collection
- Data analysis
- Design of the business plan
- Drawin-up of the business plan
- Presentation of the business plan
The business plan: correspondence

The sections of a business plan correspond to different business fields:

- Management and organization,
- Products and services,
- Market and competition,
- Marketing and sales,
- Research and development,
- Production,
- Procurement and logistics and
- Finances.
The roadmap of the business plan project
The development of the project plan.

At the same time a project schedule should be drafted, where tasks and activities are assigned to time slots and appointments are fixed:

- the set up of a project team,
- the assignment of a project manager,
- the precise definition of all roles and responsibilities,
- the precise project and resources planning

in order to facilitate a disciplined collaboration, assuring the quality of the entire process.
Data collection: Products and services

• Product catalogue
  – Sales volume in the last 3 years
  – Revenue in the last 3 years
  – Costs in the last 3 years
  – Profit margins in the last 3 years

• Product descriptions and technical specifications

• Planned product launches

• Pricing schedules

• Unique selling propositions

• Regulations and industrial standards
Data collection: Finance

• Annual financial statements and controls of the last 3 years

• Financial planning, forecast, for the current year with all respective assumptions

• Required investments and timeline

• Credit lines

• Loan agreements

• Evolution of key performance indicators (KPIs) within the last 3 years
Financial plan and control

The financial plan has to be aligned with the objectives of the different areas as well as with the strategic plan and goals.

If the financial plan deviates from the strategic plan, the management must be informed immediately so that they are able to act quickly.

In such a case two alternatives exist:

- The strategic plan cannot be kept partially and should be revised and adapted appropriately by the management.

- The partial plans or their interrelations do not allow an appropriate alignment with the strategic goals and should be revised by the task forces.
Business model
The business model

In order to develop a business model, you must consider from the very beginning who would be prepared to pay a price for your business idea.

There are two conditions you have to check:

• what product or service justifies your business idea,
• what revenue you can realize with your product or service.
When you have developed your business idea, you have to check if you can find a **target customer** who is prepared to pay a price for your services.

- what business you run
- why you run it
- what advantage and benefit you offer
- how you distinguish yourself from your competitors
- which customers you want to attract
- which customer needs you fulfil and how
- what products you manufacture
- how you manufacture and distribute these products
- which profit and growth you aim at
- with which methods you want to achieve success
Strategic goals

1. Describe your company model by means of your business model, through which your products and your services can be defined.

2. Present your market and the customers to whom you want to sell your products and services. Remember that the target customers will only be willing to pay the price if products and services correspond to their benefit expectations.

3. Your products and services determine the tasks in your company. With them you will lay the foundations for calculating and planning your resources and costs.
Company goals. The target hierarchy in an enterprise

Strategic goals are usually targets to achieve within the next 3 to 5 years.
Such goals may be:
• profit
• revenue
• growth
• market shares
• specific customers or
• specific customer groups
• products and services
• product design
• production, capacities and locations
• investments
• suppliers
### Example for the definition of goals and targets

<table>
<thead>
<tr>
<th>Goal</th>
<th>Description of the goals</th>
<th>Target value</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Return on total sales as the sum of the project business’ revenues, especially:</td>
<td>-€ 50 Mio</td>
<td>- Annual Sales</td>
</tr>
<tr>
<td></td>
<td>- Total revenue</td>
<td>- Thd.</td>
<td>- Revenue report of S.A.</td>
</tr>
<tr>
<td></td>
<td>- Revenue of the sales areas</td>
<td>- Tbd.</td>
<td>- Revenue report of S.A.</td>
</tr>
<tr>
<td></td>
<td>- Average revenue of the service areas</td>
<td>- € 200.00</td>
<td>- Revenue report of E.</td>
</tr>
<tr>
<td></td>
<td>- Average revenue per employee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit</td>
<td>Profitability figures especially:</td>
<td>-20%</td>
<td>- Annual/quater/month P&amp;L</td>
</tr>
<tr>
<td></td>
<td>- EBIT</td>
<td>- Tbd.</td>
<td>- Annual/quater/month P&amp;L; analysis per industry</td>
</tr>
<tr>
<td></td>
<td>- EBIT of the industry</td>
<td></td>
<td>Project controlling</td>
</tr>
<tr>
<td></td>
<td>- Operational minimum project margins</td>
<td>- Min. 30 % profit margin</td>
<td></td>
</tr>
<tr>
<td>Growth</td>
<td>Annual increase of the main business figures, average growth (CAGR) over 5 years</td>
<td>- 35 % p.a.</td>
<td>- P &amp; L</td>
</tr>
<tr>
<td></td>
<td>- Revenue</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Organizational structure
Operational structure. Example of a *high level process model*.

Usually one distinguishes between three different process groups:

- management processes,
- core processes and
- support processes.

The process map can help you to present a structured overview of your operational processes.
Operational structure.
Example of a high level process model.

To break down the existing activity blocks into further building blocks and conclude the required resources, people and materials.
Organizational structure

The design of the organizational structure allows you to focus on: **EITHER**

- **the essential processes** – such as management, core and support processes – or

- **the essential operational functions** – such as procurement, development, production, marketing, administration – or

- **the product lines** respectively the customer target groups.
A process-oriented organizational structure

Usually one distinguishes between three different process groups:
• management processes,
• core processes and
• support processes.
A functional organization structure
A divisional organization structure
A uniform structure / Differentiation of product cost allocations

- Name of job,
- Rank and name of the job holder,
- Aim of the job,
- Goals of the job holder,
- Tasks of the job holder,
- Demands on the job holder,
- Area of responsibility of the job holder and
- Its relationship to other jobs.

Further differentiation of product cost allocations

Additional

Differentiation of product cost allocation
Budget calendar /Mapping

### Allocation Keys

**Activity:** Confirmation from CPL heads – 2017 structure
- Data for allocation keys calculation (sq. m, IT) is provided to CO
- All allocation keys calculation (CPL CO)

**Allocation Keys:**
- 25.05
- 27.05 - 1.06
- 3.06

**OpEX consolidation**

**Activity:** HR Prefill sent to Heads (HR)
- 6.06 - 14.06
- 22.06

**Activity:** OpEX and PE BUD’17 collection from CLT (CO)
- 6.07 - 8.07
- 10.00 - 12.07
- 15.06 - 5.07

**Activity:** BUD preapproval with CFO, SBR, CLT
- 8.07 - 15.07
- 18.07 - 5.08

**Activity:** Final approval with CFO, SBR
- 27.07 - 3.08

**Activity:** BUD 2017 CLT meeting
- 12.08
- 22.08
- 0.00
Budget Instruments
Bridge «BUD-FCST-BUD»
Budget Instruments
Bridge «BUD-REF (staff rates)-BUD»
Financial Planning and Forecasting Financial Statements
Intrinsic Value: Financial Forecasting

Forecasting: Operating assumptions
- Projected income statements
- Projected additional financing needed (AFN)

Forecasting: Financial policy assumptions
- Projected balance sheets
- Weighted average cost of capital (WACC)

Free cash flow (FCF)

Value = $\frac{FCF_1}{(1 + WACC)^1} + \frac{FCF_2}{(1 + WACC)^2} + \cdots + \frac{FCF_\infty}{(1 + WACC)^\infty}$
Financial Planning Process

• Forecast financial statements under alternative operating plans.
• Determine amount of capital needed to support the plan.
• Forecast the funds that will be generated internally and identify sources from which required external capital can be raised.
• Establish a performance-based management compensation system that rewards employees for creating shareholder wealth.
• Management must monitor operations after implementing the plan to spot any deviations and then take corrective actions.
Pro Forma Financial Statements

• Three important uses:
  • Forecast the amount of external financing that will be required
  • Evaluate the impact that changes in the operating plan have on the value of the firm
  • Set appropriate targets for compensation plans
Steps in Financial Forecasting

• Forecast sales
• Project the assets needed to support sales
• Project internally generated funds
• Project outside funds needed
• Decide how to raise funds
• See effects of plan on ratios and stock price
AFN (Additional Funds Needed): Key Assumptions. Best examples

• Operating at full capacity.
• Each type of asset grows proportionally with sales.
• Payables and accruals grow proportionally with sales.
• Sales are expected to increase
• Profit margin and payout will be maintained.
Compensation and Forecasting

- Forecasting models can be used to set targets for compensation plans.
- The key is to reward employees for creating shareholder intrinsic shareholder value.
- The emphasis should be on the long run rather than short-run performance.
Multi-Year Forecasts: Buildup in Line of Credit

• If annual projections show continuing increase in the LOC’s (line on credit) balance, the board of directors would have to step in and make decisions regarding the capital structure or dividend policy:
  • Issue Long-Term Debt
  • Issue Equity
  • Cut dividends
Multi-Year Forecasts: Special Dividends

• The board of directors might decide to do something else with surplus instead of pay special dividends.
  • Buy back shares of stock.
  • Purchase short-term securities.
  • Pay down debt.
  • Make an acquisition.
Modifying the Forecasting Model

• Can maintain target capital structure each year by modifying model to issue/retire long-term debt or issue/repurchase shares of stock.
1. Analyze income and costs, make factor analysis of the gross revenue. Assess the impact of changes in revenue and profitability on gross income.
2. Automate administrative account, switch from Excel to specialized programs.
3. Calculate a business performance indicator: revenue / profit per employee
4. Calculate business performance: return on net assets
5. Calculate how many dividends the owner can take
6. Calculate the breakeven point of the business.
7. Calculate the current liquidity.
8. Calculate the financial / production cycle of a business.
9. Calculate the profit accumulated over the past year. The difference between net assets at the beginning and at the end of the year.
10. Calculate the profit for the last year by accounting for all income and costs, it should be equal to the balance sheet profit.
11. Calculate the profitability of sales, profitability of operating profit.
12. Check the tax system for risks: optimization, fragmentation, special tax regimes.
13. Count the net assets of a business. Collect all the assets of the business and subtract all liabilities.
14. Cut costs with the Zero Base Budgeting method
15. Free money from accounts receivable, stocks, suppliers.
16. Implement billing calendar
17. Make a balance for the next period
18. Make a cash flow budget for the next period
19. Make a map of the key business indicators
20. Make a profit budget for the next period
22. Open a credit line (if it is necessary, and this can be seen from the planned budgets)
23. Organize cash flow control.
24. Take an inventory of the pricing system

- Calculate business risks
- Understand the business
- Increase efficiency
Calculate business risks

1. Check the tax system for risks: optimization, fragmentation, special tax regimes.
2. Calculate the profitability of sales, profitability of operating profit.
3. Calculate the current liquidity.
Understand the business

1. Make up the financial structure of the business. Identify who earns & who spends.
2. Count the net assets of a business. Collect all the assets of the business and subtract all liabilities.
3. Calculate the profit accumulated over the past year. The difference between net assets at the beginning and at the end of the year.
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**Increase efficiency**

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