TOPIC 2: FINANCIAL PLANNING AND MANAGEMENT

2.1 The role of financial planning
- Strategic role of financial management
- Objectives of financial management – liquidity, profitability, efficiency, growth, return on capital
- The planning cycle – addressing present financial position, determining financial elements of the business plan, developing budgets, cash flows, financial reports, interpretation, maintaining record systems, planning financial controls, minimising financial risks and losses.

2.2 Financial markets relevant to business financial needs
- Major participants in financial markets including banks, financial and insurance companies, merchant banks, superannuation/mutual funds, companies, government (RBA)
- Role of the Australian Securities Exchange (ASX) as a primary market
- Overseas and domestic market influences and trends in financial markets and their implications for business financial needs

2.3 Management of funds
- Sources of funds
  - Internal – owners’ equity, retained profits.
  - External – short-term debt borrowing (overdraft, bank bills), long-term borrowing (debentures, mortgage), leasing, factoring, venture capital, grants.
- Financial considerations – matching the terms and source of finance to business purpose and structure
- Comparison of debt and equity financing, including costs and benefits, risks, gearing/leverage.

2.4 Using financial information
- The accounting framework
  - Financial statements – revenue statement, balance sheet.
  - The accounting equation and relationships.
- Types of financial ratios
  - Liquidity – current ratio.
  - Solvency – gearing debt to equity.
  - Profitability – gross profit ratio, net profit ratio, return on owners’ equity.
  - Efficiency – expense ratio, accounts receivable turnover ratio.
- Comparative ratio analysis
  - Over time, with similar businesses, against common standards.
- Limitations of financial reports
  - Historical costs, value of intangibles.

2.5 Effective working capital (liquidity) management
- The working capital ratio
- Control of current assets – cash, receivables, inventories
- Control of current liabilities – payables, loans, overdrafts
- Strategies for managing working capital – leasing, factoring, sale and lease back

2.6 Effective financial planning
- Effective cash flow management
  - Cash flow statements.
  - Management strategies – distribution of payments, discounts for early payments.
**Effective profitability management**
- Cost control – fixed and variable, cost centres, expense minimization
- Revenue controls – sales objectives, sales mix, pricing policy

**2.7 Ethical and legal aspects**
- Audited accounts, inappropriate cut-off periods, misuse of funds
- Australian Securities and Investment Commission (ASIC)
- Corporate raiders and asset stripping

**Case Studies for Financial Planning and Management:**
1. Coca-Cola Amatil
2. Oroton Group
3. Hutchison 3G Australia

**2.1 The Role of Financial Planning**

- **Strategic Role of Financial Management**

  Financial management is the planning, organising and controlling of an organisation’s financial resources to enable the organisation to achieve its financial goals.

  Financial resources = those resources in a business that have a monetary or money value.

  The long-term or strategic role of management is to ensure that a new business continues to operate, grow and provide substantial profits to the owners.

  The use of strategic plans by top level managers in financial management provides a long-term view of where the organisation is heading, how it will get there, and how to monitor progress – it gives the organisation long-term, big picture goals.

  Financial managers have to anticipate changes such as interest rate rises, actions of competitors, developments in technology and changing customer needs, as these changes may have the potential to create opportunities/threats for the business.

  For Coca-Cola Amatil (CCA):
  - The short-term role of financial planning ensures CCA has enough cash to pay employees, creditors and suppliers.
  - The strategic/long-term role of financial planning allows CCA to anticipate the impact of changes in the business environment and helps it choose investment projects that will promote growth and deliver financial rewards to shareholders.

- **Objectives of Financial Management**

  The responsibility of financial management is to make decisions about the best way to achieve the objectives of liquidity, profitability, efficiency, growth and return on capital. This will involve identifying and evaluating alternative courses of action and making recommendations.

  Sound financial management is about choosing the most appropriate strategies to ensure the financial objectives are achieved.

  **(A) LIQUIDITY**
  - Liquidity = the extent to which a business can meet its short-term financial commitments and pay debts as they fall due, and is a measure of how quickly an asset may be converted into cash – it provides a measure of how well a business manages its working capital by maintaining current assets as greater than current liabilities.
  - Effective liquidity management will ensure that the business has enough CURRENT ASSETS to meet its debt obligations, without having to frequently sacrifice business opportunities – a business may be reluctant to invest in long-term projects (which often offer higher returns) if it feels that tying up crucial funds in such ventures will jeopardise its ability to meet its obligations as they fall due.
  - Solvency refers to the ability of a business to meet its long-term financial commitments.

  **(B) PROFITABILITY**
  - Profitability = the ability of an organisation to maximise its profit and the returns (on sales, assets and capital) that results from a business’ activities (once expenses have been deducted) – it is concerned with the earning potential/performance of a business.
  - In highly competitive markets, businesses attempt to achieve the greatest possible profits by minimising costs.
  - The objectives of LIQUIDITY and PROFITABILITY can often conflict – generally, the more liquid an asset, the lower the revenues it can generate – e.g. petty cash generates no returns and costs the business money through the lost opportunities associated with its use. To balance the objectives of LIQUIDITY and PROFITABILITY, a business must hold a range of assets, balancing illiquid, high-income generating assets with liquid assets that allow it to meet its financial
obligations.

(C) EFFICIENCY

- **Efficiency** = the ability of a business to use its resources effectively in ensuring financial stability and profitability (because a firm will be able to improve its profits when it can decrease its costs).
- **Efficiency** is the ability to *minimise costs and maximise output* so that maximum profit is achieved with the lowest possible level of assets.
- Managers set objectives for efficiency because this is a way of gaining a competitive edge over other businesses – increased efficiency gives the manager the option of lowering prices and increasing market share, or maximizing profit.
- **Budgets** can play a crucial role in the planning and maintenance of cost-efficient strategies – they allow for analyses of revenue/expenses, highlighting potential growth areas for revenues.

(D) GROWTH

- **Growth** = the ability of the organisation to increase its size in the long-term, which typically means increasing sales revenue, the number of employees and market share.
- It can be achieved through *direct expansion* (using the businesses internal resources to increase the business’ sales, production capacity or workforce) or *merging/taking over* other businesses.
  - **Vertical integration:** two businesses, at different levels in the production/distribution chain, merge or takeover.
  - **Horizontal integration:** two businesses, offering similar products and in the same industry, merge/takeover.
  - **Diversification** occurs when a business merges with, or takes over, a business in an unrelated industry.

(E) RETURN ON CAPITAL/RETURN ON OWNER’S EQUITY

- **Return on capital** = the amount of profit returned to owners or shareholders as a percentage of their capital contribution.
- Managers are interested in this because their return must be sufficient to make their investment worthwhile – otherwise they will move their capital to more lucrative business investments.
- In order for a business to make strong returns on capital, it must operate efficiently and be profitable.

For CCA:
- **CCA shares** have performed well recently – rising from $2.98 in early 2000 to over $6.70 in 2004 before reaching $8-9 in 2008 (and consistently fluctuating within this range) – this result reflects the sound shareholder sentiments and future shareholder expectations which seem to be positive.

For CCA (increasing revenue + profitability are major financial objectives – it should also aim to improve liquidity, efficiency, growth and solvency to increase its competitiveness):
- In 2001, CCA’s Managing Director (Terry Davis) announced 3 core financial objectives for the company:
  - Earnings growth of 10-15% per annum.
  - Earnings per share growth of 12-15$ per annum.
  - Return on capital growth of 1-1.5% per annum.

*The Financial Planning Cycle*

The financial planning cycle refers to the continuous series of financial activities that take place in a business and that ensure the business adapts to a changing environment.

1. **Addressing the present financial position**
   - Collect all financial data to accurately determine the business’ present financial position and is concerned with an assessment of the business’ financial resources – the main reports a business will need to analyse are the profit and loss statement, balance sheet and cash-flow reports.
   - Evaluate profitability, liquidity, efficiency and return on capital as they affect the decisions made by managers.

2. **Determining the financial elements of the business plan**
   - Considering the entire business plan, the financial managers will work out the detailed short-term and long-term financial goals/objectives of the business.
   - The financial part of the plan is vital because it outlines and details how the strategies within the plan will be funded (and assists with the decisional role of management in allocating funds to various projects).
Some financial information that is incorporated in a business plan include projected revenue statements, cash flow statements and balance sheets, financial ratio analysis, break-even analysis, the finance required and the proposed sources of finance.

3. Developing budgets
- Budgets can now be constructed to give direction to management and other employees.
- Budgets are formal statements to allocate resources to different areas of the business and provide information in quantitative terms about requirements to achieve a particular purpose – they are tools of prediction, designed to predict what will happen in the business in the future.
- They provide financial information for specific business goals and are used in strategic, tactical and operational planning.
- Budgets are used both in the PLANNING and CONTROLLING process.
  - Operating budgets relate to the main activities of an organisation and may include budgets relating to sales, production, raw materials, direct labour, expenses and COGS.
  - Project budgets relate to capital expenditure and research and development.
  - Financial budgets relate to financial data - include the budgeted revenue statement, balance sheet and cash flows.

4. Cash flows
- Cash flow is possibly the most important aspect of the planning cycle - making predictions about the cash inflows and outflows of the business will help to identify times when there will be a cash shortfall or surplus.
- A cash flow budget records the expected receipts of cash (cash inflows) and expected payments of cash (cash outflows) over a period of time. They are especially important for organisations operating on a cash and credit basis.

5. Preparing Financial Reports
- Financial reports provide a summary of the financial transactions of the business, bringing together a lot of information which makes it easier for managers to understand the financial side of their operations.
- These reports are important to various business stakeholders, such as managers, creditors and owners.
- The main accounting reports are:
  - Profit and loss statement (Revenue Statement): a summary of the income earned and expenses incurred over a period of trading – helps users of the information to determine how much money has been derived as profit.
  - Balance sheet: a snapshot of the financial position of a business at any point in time – a statement that shows the overall stability of the business, is constantly changing, and shows where the business gets its money (and how it is used). Assets must always equal liabilities + owner’s equity, based on the accounting equation $A = L + OE$.
  - Cash flow statements: outline or detail the receipts and payments of cash over the trading period – they provide essential information on the business’ liquidity.

6. Interpretation of Financial Reports
- Examination of the various reports should reveal whether the financial goals of the business will be achieved.
- Financial reports are typically interpreted through financial ratio analysis – and comparisons are made to previous performances, other businesses (competitors) and the industry averages.
- ACTUAL PERFORMANCE IS COMPARED AGAINST PLANNED PERFORMANCE (as per Step 2 of the Planning Cycle)
  - Analysis is an essential element of financial planning – the reports are presented in an easy to read and understand format based on the standards and principles known as the ‘generally accepted accounting principles’.

7. Maintaining Record Systems
- Strategies to ensure information is accurate and reliable are developed so managers can make good decisions – all financial planning relies on the timely recording of financial data – each transaction should be recorded in the books of account (either manual or computerized) – information from previous years is kept on file.
- Record systems are the mechanisms employed by an organisation to ensure that data is recorded and the information provided by the record systems is accurate, reliable, efficient and accessible.
- A Management Information System (MIS) is a formal system of gathering, integrating, comparing, analysing and dispersing information effectively and efficiently – records must be regularly maintained.
8. Planning Financial Controls

- This aspect of the planning cycle is concerned with putting into place effective control tools.

- **Financial controls** are the policies and procedures that ensure that the plans of an organisation will be achieved in the most efficient way – managers need to establish a series of controls that will enable them to measure ACTUAL performance in the business in comparison to PLANNED performance.

- Some common policies and procedures that promote control within an organisation are:
  - Clear authorization and responsibility for tasks in the organisation.
  - Separation of duties – different people are responsible for different tasks.
  - Rotation of duties – staff are multi-skilled and can rotate duties.
  - Control of cash – the use of cash registers, banking cash daily, taking all money off premises over night, making payments by cheque and not cash.
  - Protection of assets – carrying out regular checks of assets and ensuring maximum security surveillance.
  - Control of credit procedures – following up overdue accounts and credit checks of customers.

- Budgets and variance reporting are financial controls used in businesses – budgets are an important planning tool, but by comparing budgets with actual results, it is also an important financial control measure. By determining the difference or variance between budgeted and actual results, changes can be made as needed. **Variance reports** show the difference between budgeted and actual performance.

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- **Financial risk** is the risk to a business of being unable to cover its financial obligations.

- In very competitive markets, the chance of making losses is higher, so the temptation to take risks is greater. **Financial planning helps to minimise the risks and the possibility of losses that may then arise by helping managers to make informed decisions** – astute managers will know how to read and interpret financial information, interpret trends and detect warning signs and market changes early.

- Hedging can transfer some risk to other businesses specialising in risk, and even the risk of unsatisfactory price movements in the future can be insured against by sophisticated financial products called **derivatives**.

- In assessing financial risk for a business, consideration must be given to the amount of borrowing, when borrowings need to be repaid, interest rates and the required level of current assets needed to finance operations – if the business is financed from borrowings, there is a higher risk – the greater the risk, the greater the expectation of profits/dividends and returns.

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Any large variations in actual and planned performance will need to be carefully examined and incorporated into the next cycle, when the business again addresses its present financial position. Often, however, large variations can be related to one-off factors that are not recurrent in nature and cannot be accounted for in future periods.

2.2 Financial Markets Relevant to the Financial Needs of Businesses

- **Financial markets** are made up of individuals, institutions and systems supplying excess funds to those who need them.
  - ‘Financial’ relates to money, and ‘market’ indicates trading activity.

- Financial markets are important for businesses because they provide access to funds, investment opportunities and contacts in managing funds, and expertise in financial market dealings.

- Financial markets are made of **FINANCIAL INTERMEDIARIES** – receive money from those with excess funds and provide finance to those wishing to borrow money – e.g. finance companies, superannuation funds and insurance companies.

- Financial markets are either **exchange-traded markets** or **over-the-counter markets**.
  - **Exchange traded markets**: traded on an authorized exchange – the ASX and Sydney Futures Exchange.
  - **Over-the-counter markets**: not traded on an exchange, but transactions take place via telephone and other means of communication; comprise four sub-markets, i.e. cash and securities markets, FOREX markets, commodity markets & derivatives markets.

- **Major Participants in Financial Markets**

As a result of the deregulation of financial markets, more participants have entered the market to provide financial services to businesses. **Globalisation** has meant that businesses can also acquire finance from international financial markets.

The major participants in financial markets are:

1. **BANKS** (the big four – ANZ, CBA, NAB, Westpac)
  - Banks are the major operators in financial markets and the most important source of funds for businesses- they receive savings as deposits from individuals,