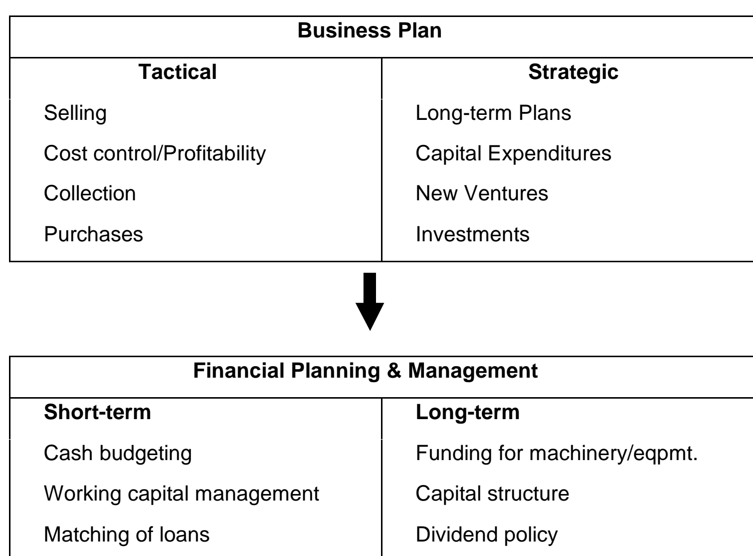
Basic Financial Planning and Management

Rationale

Each business activity requires a proper type of financing. Unfortunately, basic financing principles are sometimes lost to the businessman or, become secondary in importance. Only when problems arise are these financing issues brought to light. Therefore, the key is financial planning.

Relation to the Overall Business Plan

In addition to having a correct financing scheme for each business activity, there must be an overall strategy for sourcing and using funds. This strategy is, in turn, decided by an overall business plan. The business plan will coordinate the actions within the two main aspects of financial management: short-term and long-term management.



Business Plan	
Tactical	**Strategic**
Selling	Long-term Plans
Cost control/Profitability	Capital Expenditures
Collection	New Ventures
Purchases	Investments

Financial Planning & Management	
Short-term	**Long-term**
Cash budgeting	Funding for machinery/eqpmt.
Working capital management	Capital structure
Matching of loans	Dividend policy

In this article, we will tackle short-term financial management.

There is a myriad of useful applications for a business plan. In financial management, its most important use is in forecasting financing needs/problems. The business plan is actually the first step in financial management. It fulfills three functions:

1. **Helps the prospective lender to identify one's business goals**
2. **It informs lenders about your available resources**
3. **It keeps your present business position clear to all concerned**

Also, as will be demonstrated shortly, so-called financing problems can be remedied through non-financial means. Even if operating remedies cannot adequately address the funding problem, the operation is the root of the problem. Therefore, both borrower and lender must have a clear understanding of the underlying operation in order to design a meaningful package.

The Root Causes of Short-term Financing Problems

For short-term financing, the goals are to ensure availability of cash to finance operations and to meet current financial obligations. Why these two goals are sometimes hard to realize is demonstrated below:

IDEAL FINANCING SCHEME

1. On start-up

Activity	**Financing**
1) Purchase of machinery/equipment	Capital
2) Initial purchase of raw material, pre-op expenses	Capital

2. Operation is ongoing

Activity	**Financing**
1) Direct and overhead expenses	Sales, cash from past sales
2) Purchase of raw material, supplies	Sales, cash from past sales
3) Additional capital expenditures	Surplus from operations, additional capital infusion

WHY # 2 RARELY COMES ABOUT:

1) Sales are usually enough to cover expenses but not purchases, definitely not capital expenditures.
2) Sales are sometimes on credit
3) Purchases are sometimes excessive
4) Acquisition of new machinery is sooner (or bigger) than planned
5) # 1-4 are disincentives for infusing additional capital

Realizing that sales and initial capital will not suffice to fund an existing business is probably the first, sometimes painful, lesson for an aspiring entrepreneur. While # 2 is not unattainable, every business must consider in its plan the necessity of having to avail of outside financing. Simultaneous with this is the consideration of the benefits and risks arising from that action.

Benefits from external financing are easily appreciated. What about risks? The failure meet current financial obligations is what. This failure is so common that ensuring against it merits a no. 2 priority in short-term financial management.

Summary of Sources and Uses of Funds

Financial management is not the same as accounting. The table below proves it. You'll probably think that the activities listed describe the business *in toto*. Actually, the first job of a financial manager is to describe every aspect of a business in Peso terms. More precisely, to describe whether the activity is a use or source of cash. The planning and management part is needed when there is an unavailability of THE Peso or when not enough Pesos are produced.

Sources and savings coming from operations	**Uses / shortfall from operations**	**Sources outside of operations:**	**Uses outside of operations**
Cash from sales	Credit sales to customers	Interest income on deposits and money lent out	Interest payment
Prepayments by customers	Expenses, both scheduled and unforeseen	Borrowings from banks, affiliates, shareholders, etc.	Repayment of loan principal
Collections from past credit sales	Payment of past credit purchases	Additional capital from new or existing shareholders	Purchase of machinery, land, other investments
Deferred payment of expenses		Sale of machinery, land, other investments	Dividends and withdrawals
Deferred payment of purchases			

Having enumerated part, not all, of the possible sources and uses of funds, we come to the most important message in this article:

A business can obtain cash from so many sources besides sales. Both sources and uses can be made to work beneficially for the business. All they need is their fair share of research and planning.

Internal Sources of Funds

When you "source" funds internally, it actually means you're improving your business' operating efficiency. The improvement is aimed not towards boosting sales or cutting costs but towards increasing cash generation. This is yet another reminder that good planning and management is superior to any external financing.

Herewith are the major uses of operating funds. The highlighted statements are recommended ways to reduce cash usage (which is the same as generating cash).

Receivables

You grant credit sales to customers for various reasons. It could be those reasons are more important than having a healthy cash position. If credit sales noticeably tie up much of your cash, the non-financial solution is faster collection of receivables. Since this is easier said than done, one can do the next best thing:

Estimate average collection time and the probable percentage of uncollectibles.

This way, you can plan ways to mitigate the shortfall in cash well in advance and make credit sales work for you instead of against you.

Inventory

Maintaining a proper level of inventories is a science on its own. Obviously, businessmen are more oriented towards buyers than lenders. They'd rather see an oversupply than a stock-out. Well then, to keep excess inventories from eating up one's cash reserves, develop a monthly purchasing schedule (this is a refinement on the business plan and with the necessary cooperation of your supplier).

Set minimum levels per month and purchase new inventory so that stocks on hand plus new purchases equal next month's minimum.

A strict purchasing schedule may not always sit well with your supplier, specially if he practices trade loading (you know, selling you more than you can afford with the sole intention of filling up your warehouse or shelves. This effectively crowds out his competitors). Convince him that the set-up will optimize both your cash positions with regard to purchasing.

Credit Purchases from Suppliers

This is a much under-estimated way to save on operating funds. The key is being able to adjust the percentage of credit purchases to total purchases while following the minimum monthly inventory schedule.

Increase the level of payables to suppliers from one period to the next so that the increase is in excess of the combined increases in credit sales and ending inventory. When the reverse is occurring (receivable and inventory levels are going down), repay credit purchases at a slower rate.

Of course, suppliers know this strategy for what it is. Therefore, it's important for your supplier to know your operating turnover so that he could program his own credit sales. In most cases, he will agree to a slight "lag" in payment so as to ensure a healthy cash position.

So much depends on one's supplier.

Prepayments

If maintaining an optimum level of inventories is a science, getting customers to pay ahead of delivery is an art. Prepayments by customers, also known as advances and deposits, are generally practiced in "job order" type of businesses. This is because the time and cost to deliver a good or service could easily eat up a business' core capital. In construction, mobilization expenses are paid up-front. They cost between 10% and 15% of total project cost. Fabrication jobs usually require a 30% down payment. In real estate sales, developers begin construction only when the buyer has paid a minimum 20% down payment. Lastly, there's the well-known 3-3 in real estate leasing (3 months advance and 3 months refundable deposit).

Of the above examples, only prepayments for construction and fabrication make any sort of financing sense. In these businesses, start-up costs for a project are well in excess of a business' available funds. In real estate sales, it is unlikely that a 30% downpayment would have much impact on operating cash. In this business, the crucial source of funding is the staggered payment on previous sales. The six-month deposit requirement for real estate leasing is more of a surety than a necessary cash generating mechanism.

Design pre-payment schemes only when start-up costs are in excess of both available funds and expected cash receipts in the near future.

On the other hand, prepayment deals often carry a discount so overall profitability may suffer. Know also that other terms may be necessary to attract prepayments.

Other Means

The following suggestions are not advisable when viewed in the long-term. However, they are considered legitimate means to save funds. This is true particularly for start-up businesses. Just remember they are interim measures designed to alleviate current financing problems:

1) **Rent factory or storage space instead of buying or building**
2) **Purchase second-hand machinery at the onset**
3) **Settle for extra labor instead of labor-saving equipment**
4) **Assemble rather than manufacture**
5) **Subcontract as far as costs will allow**
6) **Buy an existing business rather than develop a totally new one**
7) **Choose only product lines that buyers will pay for in cash or on favorable credit terms**
8) **Choose your buyers! Sell only to those who pay cash or on quick credit terms**
9) **Dispense with marketing! Be a subcontractor.**

External Sources of Funds (Debt Financing)

Growth in Earnings (Back to the Business Plan!)

Reality check. We've seen how a business can generate needed cash on its own. However, we know that the vast majority of businesses avail of external funding. Why? The main "culprit" is growth. Growth in revenues and earnings is a desirable, even necessary, objective. Again, the business plan becomes useful. The mechanism to produce growth in earnings is spelled out in the plan. In other words, the business plan must have pre-determined the feasibility of future growth. If you planned on growth, the need to borrow should not come as a surprise.

Matching

Incorrect matching of source-use of funds is probably the second main cause of financing problems (after inefficient operations). There is really just one underlying principle and that is:

Short-term funding requirements should be financed by short-term borrowings. Long-term funding needs like purchase of land and machinery must be financed by long-term borrowings.

Below is a partial list of pitfalls resulting from mismatched finances:

Error	Result
Short-term loans used to finance long-term investments	1. Investment will not contribute sufficient cash within the first year to meet principal repayment 2. Current operations will be hard-pressed to generate enough cash to pay additional interest expenses. 3. Near-term shortfall in cash might negate the long-term benefits coming from the investment
Long-term loans or equity used to fund working capital	1. Operations may not be able to generate sufficient funds up to the time the loan matures. 2. Short-term funding requirements (expenses and purchases) do not lead to increased future earnings. Interest charges are an unnecessary burden. 3. Unnecessarily large cash on hand. Could lead to misuse. 4. Low returns in the case of equity funding

Another important message: financial matching must be to the borrower's advantage. By this, we mean the repayment schedule must be designed in accordance with both the borrower's funding needs and his real capacity to service debt. Specifically:

1. The duration of a short-term loan must cover the period wherein there is a projected shortfall from operations and the time when operation generates sufficient excess funds to pay back the loan.
2. Excessive borrowings and an unduly long time to repay do not offer any advantages whatsoever.
3. The duration of a long-term loan is not fixed in relation to the expected life of the asset to be acquired but to the expected earnings stream coming from that asset.

Other Guidelines:

4. Do not borrow to finance dividends and withdrawals.
5. If you invest your excess cash in marketable securities, make sure they can be liquidated ahead of scheduled interest and principal payments.
6. Do not retire an existing loan ahead of schedule unless you have cash that is not earmarked for a future investment or expenditure.

Fixed Assets Financing

Assets whose useful lives are greater than one year are usually financed by additional equity or by long-term loans. Other methods include leasing and conditional purchase.

Term Loans

A term loan is a bank loan with a maturity of more than one year. Collateral is normally in the form of chattel mortgage against equipment or property. The advantage of a term loan is that the "terms", which include the repayment schedule, can be negotiated between borrower and lender.

Conditional Sales Purchase

A conditional sales purchase of a piece of machinery is made when the manufacturer/supplier will take a purchaser's note after receiving a downpayment. The seller retains ownership of the machine until the buyer has made all the required payments over the term of the contract.

Leasing

Leasing for capital equipment entails paying rental for the use of the asset instead of making an actual purchase. A variation is a sale-leaseback wherein the business sells a piece of machinery to a leasing company and then leases it back. The only advantage here is having cash which otherwise would have been used to buy the machine.

Working Capital Financing

Line of Credit

A line of credit is an agreement made with a bank to support working capital. It is simply a negotiated ceiling amount that the business can borrow provided certain conditions are

met. The bank can cancel the line at any time. The outstanding loan amount can go up or down, as the business requires (within the agreed ceiling, of course). Interest is charged only to the outstanding amount.

Character Loans

Character loans are given to individuals who are reckoned to have an excellent credit rating. These are generally un-collateralized loans for the short term.

Receivables Financing (Factoring)

Factoring is done to finance receivables from buyers. Factors are companies that purchase your business' receivables. Some factors go into a continuous agreement wherein they become responsible for granting credit sales to the business' usual buyers. In short, they absorb the risks behind credit sales. The added cost to the business is the discount on the collected amount. Also on the downside, factors often require a sizable volume of transacted sales and the business' buyers must have good credit ratings.

Inventory Financing

Inventory financing by banks can be had, usually up to 75% of the total value of raw material, work-in-process and finished goods. This method, however, is difficult to negotiate when your business is relatively new. Why? The bank will assume a large portion of your business' risk. Therefore, it wants to see a stable and well-established operation.

Budgeting / Cashflow

After sales forecasting, budgeting is probably the most important ingredient to a business' success. There is really no standard format to suite all types of enterprises. Better to develop one's own format based on the one given in this section.

A cash budget is a tool for determining a business' cash condition in the future. As such, it must capture all activities within a period. Also, the importance of accuracy in forecasting is highlighted. Forecasted figures; not just for sales but for mundane items like receivables collections, credit terms from suppliers and payment of utilities must be reviewed before and after the budget is prepared.

Recommended format.

It is advisable to prepare a monthly cash budget for the coming 12 months. Your market forecast, operating plan and projected earnings must therefore provide information with sufficient detail.

First, enter the sources and uses of cash from operations. Asiatrust Bank uses the UCA format which is similar to an income statement but with adjustments coming from the balance sheet.

Transaction (in thousand Pesos)	**Month 1**	**Month 2**	**Month 3**	. . .	**Month 12**
Total sales	1,000	1,500	1,300	. . .	1,700
Less: Credit sales for the period	(200)	(300)	(260)	. . .	(340)
Add: collection from past credit sales	150	200	300	. . .	320
Total Cash from Selling (CS)	**950**	**1,400**	**1,340**	. . .	**1,680**
Less: Direct costs	(600)	(900)	(780)	. . .	(1,020)
Less: Total Purchases	(300)	(350)	(200)	. . .	(500)
Add back: Purchases on Credit	100	150	75	. . .	200
Less: Payment on past credit purchases	(50)	(100)	(150)	. . .	(175)
Cash Production Cost (CPC)	**(850)**	**(1,200)**	**(1,055)**	. . .	**(1,495)**
CS – CPC = Gross Cash Profits (GCP)	**100**	**200**	**285**	. . .	**185**
Less: Operating Expenses (Op Exp)	(100)	(100)	(100)	. . .	(150)
Less: Taxes	(10)	(15)	(8)	. . .	(25)
Net Operating Cash (NOC)	**(10)**	**85**	**177**	. . .	**10**
Less: Interest and Bank Charges	(20)	(30)	(10)	. . .	(5)
Less: Dividends/Withdrawals	(5)	(5)	(5)	. . .	(10)
Total Financing Charges	**(25)**	**(35)**	**(15)**	. . .	**(15)**
Net Cash Income	(35)	50	162	. . .	(5)
Beginning Cash	10	10	25	. . .	10
Surplus/Deficit	**(25)**	**60**	**187**	. . .	**5**
Bridge Financing	35	(35)	(40)	. . .	5
Ending Cash	**10**	**25**	**147**	. . .	**10**

Explanation

In the above example, we assumed a minimum cash balance of 10,000 Pesos. In month 1, the operation incurred a deficit of 25,000. The company borrowed 35,000. In doing so, it covered the deficit and had an ending balance of 10,000.

At the end of month 2, it used the surplus to repay last month's 35,000 borrowing and still had 25,000 ending cash. Note that ending cash in month 3, following repayment of 40,000 in previous borrowings, had ballooned to 147,000.

Subsequent expenses and purchases between months 4 and 11 depleted this surplus so that in month 12, it needed to borrow 5,000 to maintain the minimum 10,000.

The required monthly bridge financing is automatically "plugged" to result in an ending cash balance of at least 10,000. However, a single month deficit may be avoided simply by planning a higher minimum cash balance. Should the deficit be unusually large or, if you have several consecutive "deficit" months, that's when bridge financing becomes necessary. Again, should you decide on a bank loan to bridge your expected deficit, be sure to schedule repayment in such a way that the operation has sufficient time to generate a surplus.

How does the above cash budget become a management tool?

First, notice that you have forecasted things like sales, expenses, purchases and taxes. These four items comprise your day-to-day operations. That is why, the net operating cash figure is a very important indicator. It tells you whether or not your operation can generate sufficient cash to meet interest charges and dividend requirements.

Second, you now know your operation can suffer from cash shortfalls in some months and generate a large surplus in others. From that, determining the required bridge financing becomes mechanical.

Your financing problems aren't over yet!

The above cash budget is only for operating cash management. Financing for capital expenditures is treated separately. Also, we have not addressed in our matching strategy the issue of return on capital. The aforesaid issue will be tackled in the next article.

***