Financial Planning

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Introduction:

- Every business unit whether it is an industrial establishment, a trading concern or a construction company needs funds for carrying on its activities successfully.
- It requires funds to acquire fixed assets like machines, equipment, furniture etc. and to purchase raw materials or finished goods, to pay its creditors, to meet its day-to-day expenses, and so on. In fact, availability of adequate finance is one of the most important factors for success in any business.
- However, the requirement of finance, now-a-days, is so large that no individual is in a position to provide the whole amount from his personal sources.
- So the businessman has to depend on other sources and use various ways to raise the necessary amount of funds.
- Every businessman has to be very careful not only in assessing the firm’s requirement of finance but also in deciding on the forms in which funds are raised and utilized.

Meaning of Financial Planning:

Planning is a systematic way of deciding about and doing things in a purposeful manner. When this approach is applied exclusively for financial matter, it is termed as financial planning.

- In other words, In connection with any business enterprise, it refers to the process of estimating a firm's financial requirements and determining pattern of financing. It includes deterring the objectives, policies, procedures and programmes to deal with financial activities.
- Thus, financial planning involves:

1. Estimating the amount of capital to be raised;
2. Determining the pattern of financing i.e., deciding on the form and proportion of capital to be raised;
3. Formulating the financial policies and procedures for procurement, allocation and effective utilization of funds.

•Definition of financial planning:

In simple words Financial Planning can be defined as "the process of estimating the capital required and determining it's composition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise."

- **According to Cohen and Robbins Financial planning should:** Determine the financial resources require to meet the company's operating programme. Forecast the extent to which these requirements will be met by internal generation of funds and the extent to which they will be met from external sources. Develop the best plans to obtain the required external funds. Establish and maintain a system of financial control governing the allocation and use of funds. Formulate programmes to provide the most effective profit-volume-cost relationship. Analyze the financial results of operations Report facts to the top management and make recommendations on future operations of the firm.

- **Meaning of Financial Plan:**

- A financial plan is a statement estimating the amount of capital requirements and determining its composition. It emphasizes on the following aspects-How much fund is require? When the fund is require? How the fund should be raised? How to use the funds?

• Objectives of Financial Planning:

1. **Determining capital requirements-** This will depend upon factors like cost of current and fixed assets, promotional expenses and long- range planning. Capital requirements have to be looked with both aspects: short- term and long- term requirements.
2. **Determining capital structure-** The capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business. This includes decisions of debt- equity ratio- both short-term and long- term.
3. **Framing financial policies** with regards to cash control, lending, borrowings, etc.
4. A finance manager **ensures that the scarce financial resources are maximally utilized in the best possible manner** at least cost in order to get maximum returns on investment.

• Importance of Financial Planning:

- Financial Planning is process of framing objectives, policies, procedures, programmes and budgets regarding the financial activities of a concern. This ensures effective and adequate financial and investment policies. The importance can be outlined as-

1. Adequate funds have to be ensured.
2. Financial Planning helps in ensuring a reasonable balance between outflow and inflow of funds so that stability is maintained.
3. Financial Planning ensures that the suppliers of funds are easily investing in companies which exercise financial planning.
4. Financial Planning helps in making growth and expansion programmes which helps in long-run survival of the company.
5. Financial Planning reduces uncertainties with regards to changing market trends which can be faced easily through enough funds.
6. Financial Planning helps in reducing the uncertainties which can be a hindrance to growth of the company. This helps in ensuring stability an d profitability in concern.

- **ESSENTIALS/ CHARACTERISTICS OF A SOUND FINANCIAL PLAN**
  - While preparing a financial plan for any business unit, the following aspects should be kept in view so as to ensure the success of such exercise in meeting the organisational objectives.

(a) **The plan must be simple.** Now-a-days you have a large variety of securities that can be issued to raise capital from the market. But it is considered better to confine to equity shares and simple fixed interest debentures.

(b) **It must take a long term view.** While estimating the capital needs of a firm and raising the required funds, a long-term view is necessary. It ensures that the plan fully provides for meeting the capital requirement on long term basis and takes care of the changes in capital requirement from year to year.

(c) **It must be flexible.** While the financial plan is based on long term view, one may not be able to properly visualise the possible developments in future. Not only that, the firm may also change its plans of expansion for various reasons. Hence, it is very necessary that the financial plan is capable of being adjusted and revised without any difficulty and delay so as to meet the requirements of the changed circumstances.

(d) It must ensure optimal use of funds. The plan should provide for raising reasonable amount of funds. As stated earlier, the business should neither be starved of funds nor have surplus funds. It must be strictly need based and every rupee raised should be effectively utilised. There should be no idle funds.

(e) The cost of funds raised should be fully taken into account and kept at the lowest possible level. It must be ensured that the cost of funds raised is reasonable. The plan should provide for a **financial mix** (combination of debt and equity) that is most economical in terms of cost of capital, otherwise it will adversely affect the return on shareholders' funds.

(f) Adequate liquidity must be ensured. Liquidity refers to the ability of a firm to make available the necessary amount of cash as and when required. It has to be ensured in order to avoid any embarrassment to the management and the loss of goodwill among the investors. In other words, the investment of funds should be so planned that some of these can be converted into cash to meet all possible eventualities.

Steps in Financial Planning

Whether the business is big or small, existing or a new business, this function has to be performed. At the time of promotion, this function is performed by the promoter.

1. ***Establishing objectives :***

- Business enterprise operate in a dynamic society and in order to take advantage of the changed economic conditions, financial planning should establish both short-term and long run objectives.
- Financial objective of any business enterprise is to employ capital in whatever proportion necessary to increase the productivity of remaining factors of production over the long run.
- The long run goal of any firm is to use capital in correct proportion. The financial objective should be clearly defined.
- The concern should take advantage of prevailing economic situation.

2. *Formulating financial policies :*

- Financial policies are guides to all action which deals with procuring, administrating and distributing the funds of business firms. These policies may be classified into several broad categories:

(a) Policies governing the amount of capital required by the firm to achieve their financial objectives.
(b) Policies to achieve and determine control by the parties who furnish the capital.
(c) Policies which act as a guide in the use of debt or equity capital.
(d) Policies which guide management in the selection of sources of funds.
(e) Policies which govern credit and collection activities of an enterprise. These should be clear cut plans of raising the required funds and their possible uses. The current and future needs for funds should be considered in the financial plans.

3. ***Forecasting :***

- A fundamental requisite is the collection of facts.
- However, where financial plans concern the future and facts are not available, financial management is required to forecast the future in order to predict the variability of factors influencing the type of policies the enterprise formulates.
- This involves a thorough study of the company's past performance to identify trends.
- These trends are projected into the future and modified taking into account events or trends expected to occur in the future.

4. *Formulation of Procedures :*

- Financial planning are broad guides which to be executed properly, must be translated into detailed procedures.
- If a policy is to raise short-term funds from banks, then a procedure should be laid to approach the lenders and the persons authorized to initiate such action.
- Financial planning is the work of top management.
- Financial planning is a part of a larger planning process in an organization.

5. *Providing for flexibility :*

- The financial planning should ensure proper flexibility in objectives, policies and procedures to adjust according to the changing economic situations.
- The changing economic environment may offer new opportunities.
- The business should be able to make use of such situations for the benefits of the concern.
- A rigid financial planning will not let the business use new opportunities.

Financial Planning Process:

- The financial planning process is a logical, six-step procedure:

Step 1: Determine Current Financial Situation

Step 2: Develop Financial Goals

Step 3: Identify Alternative Courses of Action

Step 4: Evaluate Alternatives

Step 5: Create and Implement a Financial Action Plan

Step 6: Reevaluate and Revise Plan

- **Basic Considerations:**

  Every concern had to formulate a financial plan that would suit the specific circumstances in which it is operating. A concern should bear in mind certain considerations or principles while formulating or devising its financial plan :

1. ***Simplicity of purpose :*** Financial plan should be drafted in terms of the purpose for which the enterprise is organized. It should contain a simple financial structure that can be implemented and managed easily and understood clearly by all. In short the number of securities should be the minimum possible.

2. ***Optimum use or intensive use :*** A wasteful use of capital is almost as bad as inadequate capital. A financial plan should be such that it will provide for an intensive use of funds. Funds should not remain idle nor should there be any paucity of it. The financial planners should keep in view the proper utilization of funds in the context of overall objective of maximization of wealth. Again they should see that there is a proper balance in maintenance between long-term and short-term funds, since the surplus of one will not be able to offset the shortage of the other.

3. ***Based on clear-cut objectives :*** Financial planning should be done by keeping in view the overall objectives of the company. It should aim to procure funds at the lowest cost so that profitability of the business is improved.

4. ***Long-term view :*** Financial planning should be formulated keeping in view the long-term requirements and not just the immediate or short-term requirements of the concern. This is because financial planning originally formulated would continue to operate for a long time after the formation of the concern.

5. ***Flexibility :*** The financial planning should be such that it can be modified or changed according to the changing needs of the business with minimum possible delay. There may be scope for raising additional funds if fresh opportunities occur. Flexibility in a plan will be helpful in coping with the demands of the future. Management should be ready to revise or completely change the firm's short-run objectives, policies and procedures in order to take advantage of changing conditions.

6. ***Planning foresight :*** Foresight is essential for any plan of business operations so that capital requirements may be assessed as accurately as possible. Accurate forecasts are required to be made regarding the future scope of operations of the concern, technological developments, etc. The making of accurate forecasts require foresight on the part of financial planners. A financial plan visualized without foresight may fail to meet the present as well as the future requirements of funds and bring disaster to the concern.

7. ***Financial contingencies :*** The financial planning should make adequate provisions of funds for meeting the contingencies likely to arise in the future. This principle does not mean that large amount of funds should be kept idle as reserves for unforeseen contingencies. It simply means that while formulating the financial plans, the financial planners should make proper forecasts of the contingencies likely to arise in the future and make adequate provisions for funds for meeting the future contingencies.

8. ***Solvency \ Liquidity :*** The plan should take proper care of solvency because many of the companies have failed by reason of insolvency. There should be adequate liquidity in the financial plans. Liquidity means the availability of cash for the concern whenever required, for making payments on dates when they are due. This will ensure credit worthiness and goodwill to the concern and funds become available to it on very reasonable terms. It acts as a shock absorber in the event of business operations deviating from the normal course. It gives the financial plan a certain degree of flexibility. Above all, it will help in avoiding embarrassment to the management and a loss of reputation of the concern in the eyes of the public. Proper forecasting of future payments will be helpful in planning liquidity.

9. ***Profitability :*** A financial plan should maintain the required proportion between fixed charge obligations and the liabilities in such a manner that the profitability or the organization is not adversely affected. The most crucial factor in financial planning is the forecast of sale, for sales almost invariably represent the primary source of income and cash receipts. Besides, the operations of a business are geared to the anticipated volume of sales.

10. *Economy :* The financial plan should also ensure economy. It should ensure that the cost of raising funds is minimum. This is possible by having a proper debt-equity mix in the capital structure. The cost of capital is an important element in the formulation of a financial plan. An excessive burden of fixed charges on its earnings might inflate its cost of capital.

11. *Conservative :* A financial plan should be conservative, in the sense that the debt capacity of the plan should not be exceeded.

12. *Varying risks :* The financial plan should provide for ventures with varying degrees of risks so that it might enable a company to achieve substantial earnings from risky ventures.

13. *Practical :* A plan should be such that it should serve a practical purpose. It should be realistic and capable of being put to use.

14. *Availability :* The source of finance which a corporation may select, may be available at a given point of time. If certain sources are not available, the corporation may even prefer to violate the principle of suitability. Availability sometimes bears no relation to cost. A corporation cannot always choose its source of funds. Availability of different kinds of funds often plays an important part in a firm's decision to use a debt or equity. This aspect may be considered while formulating a plan.

15. *Investor's preference or temperament :* Preferences of investors are different. Some who are bold and venturesome prefer equity shares. Some investors who are cautious go for debentures. As such, the financial plan should keep in mind the temperament or the preference of investors, i.e. the financial plan should be formulated in accordance with preferences of investors.

16. *Timing :* A sound financial planning involves effective timing in the acquisition of funds. The key to effective timing is correct forecasting. This would depend upon the understanding of the management as to how business cycles behave during different phases of business operations.

17. *Communication :* With outside parties including investors and other suppliers of funds, communication is an essential prerequisite. The outside parties would then know that the management is trying to control its business effectively and what it is doing.

18. *Implementation :* A firm should see to it that plans are actually carried out. The data should be available at any level in detail and in certain frequency. This would enable a firm to take timely and corrective action whenever necessary.

19. *Control :* The capital structure of a firm may be such as to ensure that control does not pass in the hands of outsiders. For this purpose the use of debt financing may be encouraged. However stock should be broadly distributed to facilitate the maintenance of control.

20. *Less dependence on outside sources :* Long-term financial planning should aim to reduce dependence on outside sources. This can be possible by retaining a part of profits for ploughing back. The generation of own funds is the best way of financing operations. In the beginning, outside funds may be a necessity but financial planning should be such that dependence on such funds may be reduced in due course of time.

21. *Nature of industry :* The needs for funds are different for various industries. The asset structure, element of seasonality, stability of earnings, are not common factors for all industries. These variables will influence or determine the size and structure of financial requirements.

22. *Standing of the concern :* This will influence a decision about the financial plan. The goodwill of the concern, credit rating in the market, past performances, attitude of the management are some of the factors which will be considered in formulating a financial plan.

23. *General economic conditions :* The prevailing economic conditions at the national level and international level will influence a decision about financial plan. These conditions should be considered before taking any decisions about sources of funds. A favourable economic environment will help in raising funds without any difficulty. On the other hand, uncertain economic conditions may make it difficult for even a good concern to raise sufficient funds.

24. *Government control :* The government policies regarding issue of shares and debentures, payment of dividend and interest rates, entering into foreign collaborations, etc. will influence a financial plan. The legislative restrictions on using certain sources, limit of dividends, etc. will make it difficult to raise funds. So Government controls should be properly considered while selecting a financial plan.

•Limitations of Financial Planning

1. *Difficulties in forecasting :* Plans are decisions and decisions require facts about the future. Financial plans are prepared by taking into account the expected situations in the future, which is always uncertain. Since future conditions cannot be forecasted accurately, the adaptability of planning is seriously limited. One way to offset the limitation is to improve forecasting techniques. Another way to overcome this limitation is to revise plans periodically. The development of variable plans, which take changing conditions into consideration, will go a long way in eliminating this limitation.

2. *Difficulty in change :* Another serious difficulty in planning is the reluctance or inability of the management to change a plan once it has been made, for several reasons. Assets may have to be purchased again, raw materials and cost may have to be incurred.

3. *Rapid change :* The growing mechanism of industry is bringing rapid changes in industrial processes. The methods of production, marketing devices, consumer preferences, create new demand every time. The incorporation of new changes require a change in financial plan every time. Once investments are made in fixed assets, then these decisions cannot be reversed. It becomes very difficult to adjust the financial plan for incorporating fast changing solutions. Unless a financial plan helps the adoption of new techniques, its utility becomes limited.

4. *Problem of coordination :* Financial functions is the most important of all functions. Other functions also influence a decision about financial plan. While estimating financial means, production policy, personnel requirements, marketing possibilities are all taken into account. Unless there is proper coordination among all the functions, preparing of financial plan becomes difficult. Often there is a lack of coordination among different functions. Even indecision among personnel disturbs the process of financial planning.