



Class: FYBSc

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Chapter: Unit 4 Chapter 2

Chapter Name: Financial planning

Today's Agenda

1. Introduction
 1. Short term planning
 2. Short term v/s long term financial decisions
 3. Cumulative capital requirement
2. Cash cycle
 1. Cash budgeting
 2. Long term financial planning
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 4. Growth and external financing

1 Introduction



Financial planning is the process of taking a comprehensive look at your financial situation and building a specific financial plan to reach your goals.

Two types of financial planning:

1. Short term planning:
2. Long term planning :

1.1 Short term planning

- The focus is on ensuring that the firm does not run out of cash. Short-term planning is, therefore, often termed cash budgeting.
- Short-term decisions are easier than long-term decisions, but they are not less important. A firm can identify extremely valuable capital investment opportunities, find the precise optimal debt ratio, follow the perfect dividend policy, and yet founder because no one bothers to raise the cash to pay this year's bills. Hence the need for short-term planning.
- Short-term planning rarely looks further ahead than the next 12 months.
- It seeks to ensure that the firm has enough cash to pay its bills and makes sensible short-term borrowing and lending decisions

1.2 Short term v/s long term financial decisions

Short-term financial decisions differ in two ways from long-term decisions such as:

1. They generally involve short-lived assets and liabilities.
2. They are usually easily reversed .

For example, a 60-day bank loan with an issue of 20-year bonds. The bank loan is clearly a short-term decision. The firm can repay it two months later and be right back where it started. A firm might conceivably issue a 20-year bond in January and retire it in March, but it would be extremely inconvenient and expensive to do so. In practice, the bond issue is a long-term decision, not only because of the bond's 20-year maturity but also because the decision to issue it cannot be reversed on short notice.

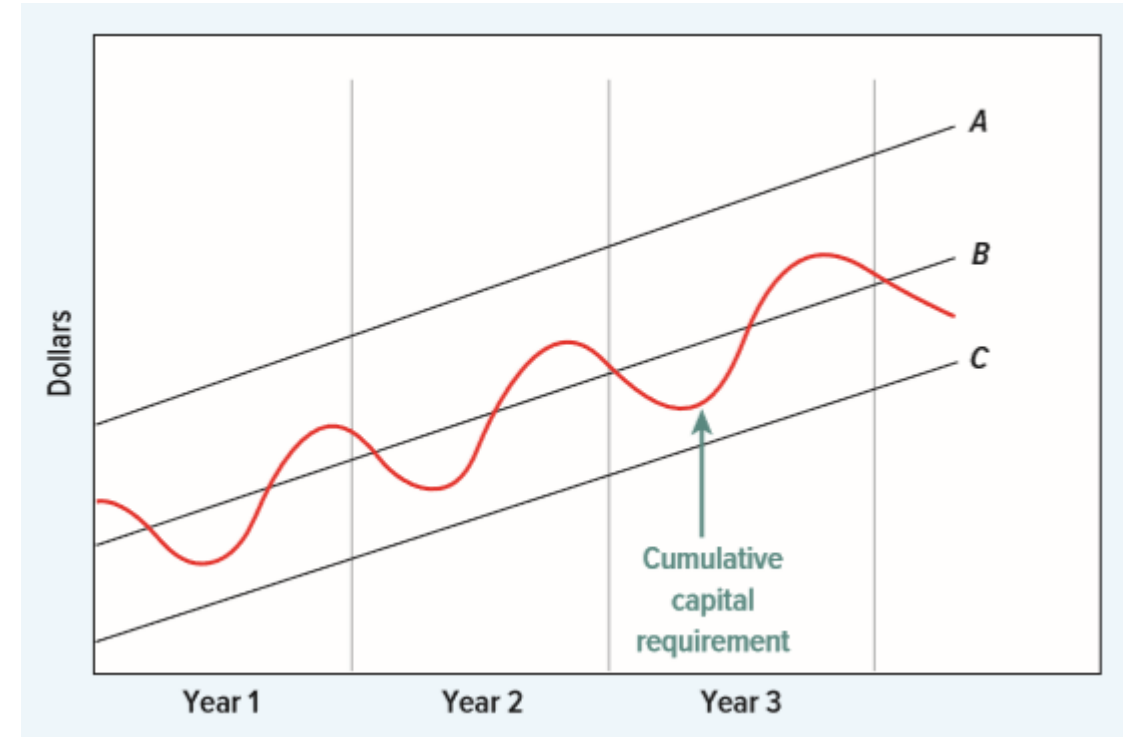
1.3 Cumulative capital requirement

The capital requirement is the sum of funds that your company needs to achieve its goals.

- All businesses require capital—that is, money invested in plant, machinery, inventories, accounts receivable, and all the other assets it takes to run a business. These assets can be financed by either long-term or short-term sources of capital. This is called total investment the firm's cumulative capital requirement of a firm.
- The cumulative capital requirement grows irregularly.
- When long-term financing does not cover the cumulative capital requirement, the firm must raise short-term capital to make up the difference. When long-term financing more than covers the cumulative capital requirement, the firm has surplus cash available. Thus the amount of long-term financing raised, given the capital requirement, determines whether the firm is a short-term borrower or lender.

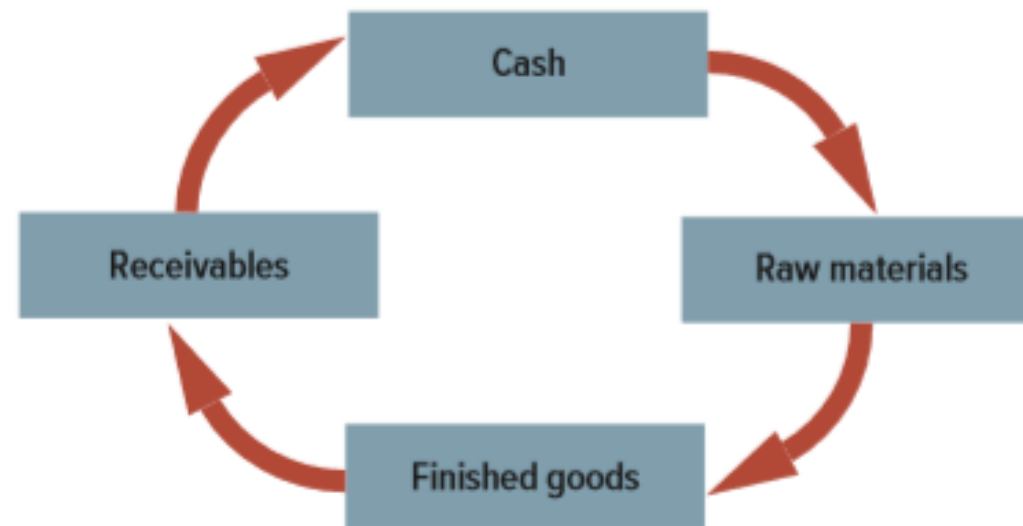
1.3 Cumulative capital requirement

- Strategy A implies a permanent cash surplus, which can be invested in short-term securities.
- Strategy C implies a permanent need for short-term borrowing.
- Under B, which is probably the most common strategy, the firm is a short-term lender during part of the year and a borrower during the rest.



2 Cash cycle

The company conducts a very simple business. It buys raw materials for cash, processes them into finished goods, and then sells these goods on credit. The whole cycle of operations looks like this:



2 Cash cycle

The delay between initial investment in inventories and the final sale date is called the **inventory period**.

The delay between the time that the goods are sold and when the customers finally pay their bills is the **accounts receivable period**.

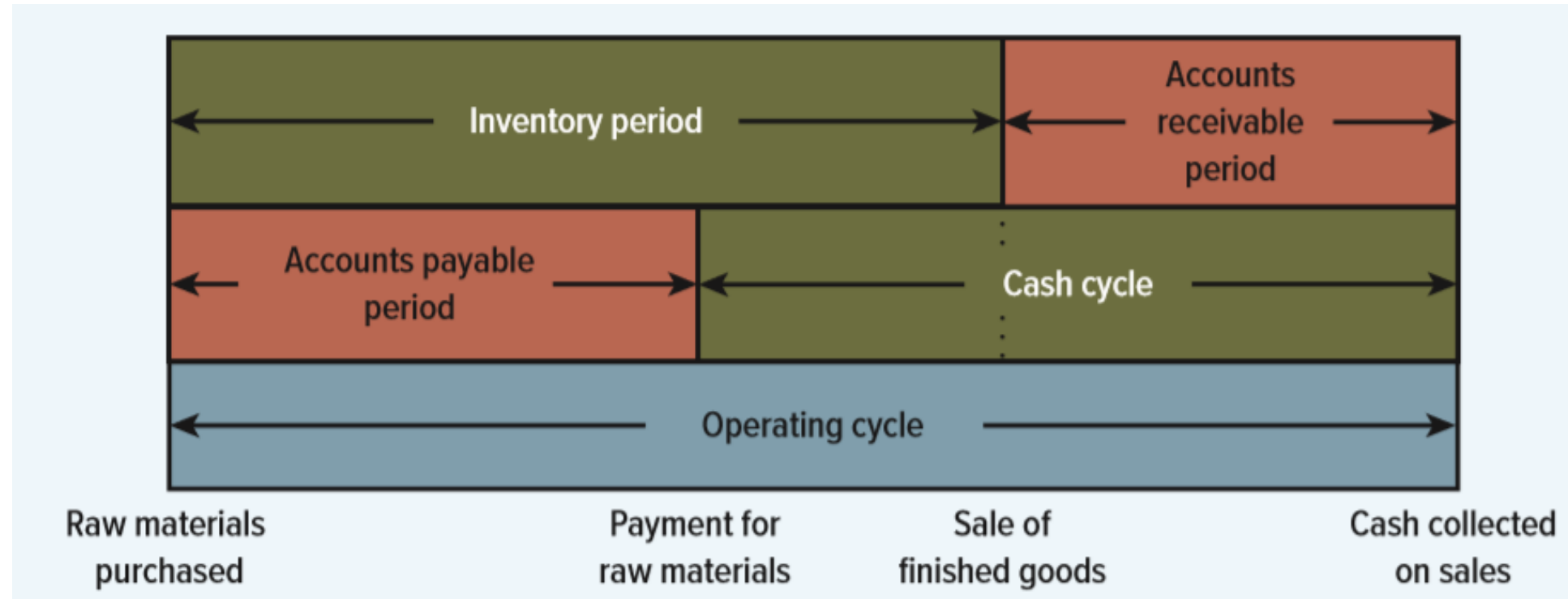
The total length of time from the purchase of raw materials until the final payment by the customer is termed the operating cycle:

$$\text{Operating cycle} = \text{inventory period} + \text{accounts receivable period}$$

The company starts by purchasing raw materials, it does not pay for them immediately. The longer that it defers payment, the shorter the time that the firm is out of cash. The interval between the firm's payment for its raw materials and the collection of payment from the customer is known as the cash cycle or cash conversion period:

$$\begin{aligned}\text{Cash cycle} &= \text{operating cycle} - \text{accounts payable period} \\ &= (\text{inventory period} + \text{accounts receivable period}) - \text{accounts payable period}\end{aligned}$$

2 Cash cycle



2.1 Cash budgeting

A cash budget is an estimation of the cash flows of a business over a specific period of time. This could be for a weekly, monthly, quarterly, or annual budget. This budget is used to assess whether the entity has sufficient cash to continue operating over the given time frame. The cash budget provides a company insight into its cash needs (and any surplus) and helps to determine an efficient allocation of cash.

There are three steps to preparing a cash budget:

Step 1: Forecast the sources of cash. The largest inflow of cash usually comes from payments by the firm's customers.

Step 2: Forecast the uses of cash.

Step 3: Calculate whether the firm is facing a cash shortage or surplus. The company then uses these forecasts to draw up a plan for raising or investing cash.

2.2 Long term financial planning

- A coherent long-term plan demands an understanding of how the firm can generate superior returns by its choice of industry and by the way that it positions itself within that industry.
- Smart financial managers need to plan for the long term and to consider the financial actions that will be needed to support the company's long-term growth.
- Long-term planning involves capital budgeting on a grand scale. It focuses on the investment by each line of business and avoids getting bogged down in details.

2.3 Why Build Financial Plans?

Firms spend considerable time and resources in long-term planning. What do they get for this investment?

1. Contingency Planning
2. Considering Options
3. Forcing Consistency

2.4 Growth and External Financing

Some general relationships between a firm's growth objectives and its financing needs:

1. At higher growth rates, the firm requires additional capital.
2. At lower growth rates, reinvested earnings exceed the addition to assets and there is a surplus of funds from internal sources; this shows up as negative required external financing.

If net assets are proportional to sales, then the additional assets required to support any growth in sales is

Additional net assets required = growth rate $\times$ initial net assets

Required external financing = (growth rate $\times$ initial net assets) – reinvested earnings

2.4 Growth and External Financing

The maximum growth rate that a firm can achieve without raising external funds is called the internal growth rate. If we set external financing to zero in the previous equation, then we can solve for the internal growth rate

Internal growth rate = reinvested earnings / net assets

OR

Internal growth rate = plowback ratio × return on equity × equity/net assets

A firm can achieve a higher growth rate without raising external capital if

- (1) it plows back a high proportion of its earnings,
- (2) it has a high return on equity (ROE), and
- (3) it has a low debt-to-asset ratio