Centre for Enterprise
Sustainability

Efficiency Through Sustainability

FINANCE FOR NON-FINANCIAL MANAGERS

(Finance Accounting and Budget)

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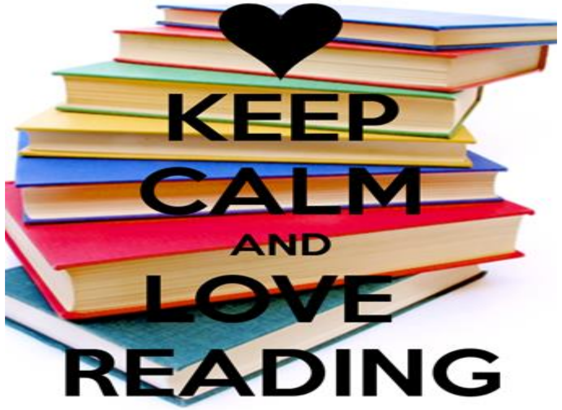
Course Outline

1. Section A:

Introduction to Accounting Information and Statements

2. Section B:

Introduction to Finance (Corporate Finance)



3. Section C

Budgeting

SOME FINANCIAL TERMS

Financial Term	Description
Assets	These are things which are owned by a business such as buildings, vehicles, stock and money in the bank.
Audit	An audit is an independent examination of an organisation's records and financial statements (report and accounts).
Bond	A bond is a written promise to repay a debt at an agreed time and to pay an agreed rate of interest on that debt.
Capital	This is the assets (or money) available to an organisation to re-invest and create new assets.
Capital Assets	A long-term tangible piece of property (i.e. buildings, equipment etc.) that a firm owns and uses in the production of its income and is not expected to be consumed or converted into cash any sooner than at least one year's time.
Capital Budget	This is a plan a company uses for raising large and long-term sums for investment in property, over a period greater than the period considered under an operating budget.
Capital Expenditure	If you spend money buying or improving fixed assets, it is called capital expenditure.
Capital Gain	You make a capital gain if you sell or dispose of a long-term asset (such as a building) for more than it cost you.
Corporation Tax	This is a tax companies pay on their profits.
Current Assets	These are short-term *assets* which are constantly changing in value, such as stocks, *debtors* and bank balances.
Debt Financing	This is a type of financing which involves borrowing money with a promise to repay the amount borrowed, plus interest. Debt

SECTION A

Introduction to Accounting Information and Statements

Section A: Contents

- **Introductory to Accounting Information and Statement**
  - Accounting as a language/accounting information
  - Users of accounting information
    - External users
    - Internal users
  - General purpose of financial statement
  - Importance of accounting principles in understanding financial statements
  - Elements of basic accounting equation
  - Different financial statements
    - Statement of financial position (Balance sheet)
    - Statement of financial position (Income statement)
    - Statement of cash flow (changes in cash position)

Accounting Information

Accounting communicates the financial condition/performance of business to users

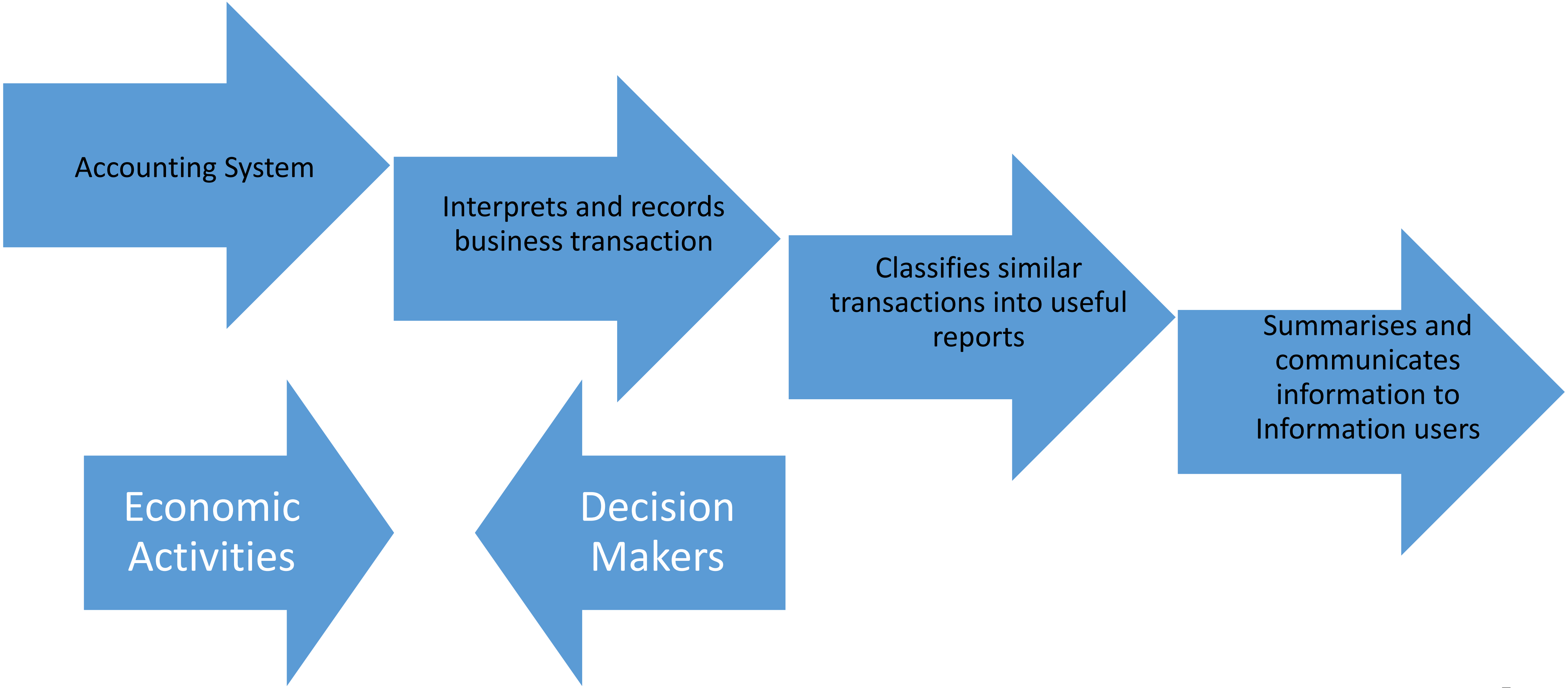
Accounting provides information for decision making

Referred to means to an “end”

End = decision made using available and reliable information

Accounting: Information for Decision Making

Accounting system as generator of reliable information



Users of Accounting Information (External)

- **External Users of Accounting (Financial) Information**
  - Owners/ Investors
  - Creditors
  - Labour Unions
  - Government Agencies
  - Suppliers
  - Customers
  - Trade Associations
  - General Public

Objectives of Financial (External) Accounting Information

- Information useful in making investment and credit decisions
- Information useful in assessing amount, timing and uncertainty of future returns
- Information about economic resources, claims to resources, and changes in resources and claims

Characteristics of Externally Reported Information

Usefulness Enhanced via Explanation

Means to an End

Broader than Financial statement

Based on General-Purpose Assumption

Historical in Nature

Results from Inexact and Approximate Measures

Users of Accounting Information

- **Internal Users of Accounting (Managerial) Information**
  - Board of Directors
  - Chief Executive Officer
  - Vice Presidents
  - Business Managers
  - Plant Managers
  - Store Managers
  - Line Supervisors

Objectives of Managerial (Internal) Accounting Information

- Information about decision-making for the authority, for support, for evaluating, and for rewarding performance
- Information useful in assessing both past performance and future directions of the enterprise
- Information useful to help the enterprise achieve its goal, objectives and mission

Characteristics of Internally Reported Information

Means to an End

Timeliness

Identify Decision-Making Authority

Measures of Efficiency and Effectiveness

Orientation Towards Future

Integrity of Accounting Information

- Generally Accepted Accounting Principles (GAAP)
- Financial Accounting Standard Board (FSB)
- Internal Control Structure
- Audits of Financial Statements
- And Others

Accounting Principles

- **GAAP**
  - widely accepted set of rules applied in preparing accounting statement.
  - standardises the accounting concepts, principles and procedures.

- **The basic accounting principles and concepts:**
  - Business Entity. A business is a separate entity from the owner(s) and should be treated separately....
  - Going Concern....
  - Monetary Unit....
  - Historical Cost....
  - Matching....
  - Accounting Period....
  - Conservatism....
  - Consistency….

Introduction to Financial Statements

- **Nature and general purpose of Financial Statement**

- Declaration of information in financial terms
  - Fair and accurate information

- Describes certain attributes of an enterprise

- Important for decision making
  - Particularly to owners and creditors.

Three Primary Financial Statements

Balance Sheet

- Describes where the enterprise stands at a specific date

Income Statement

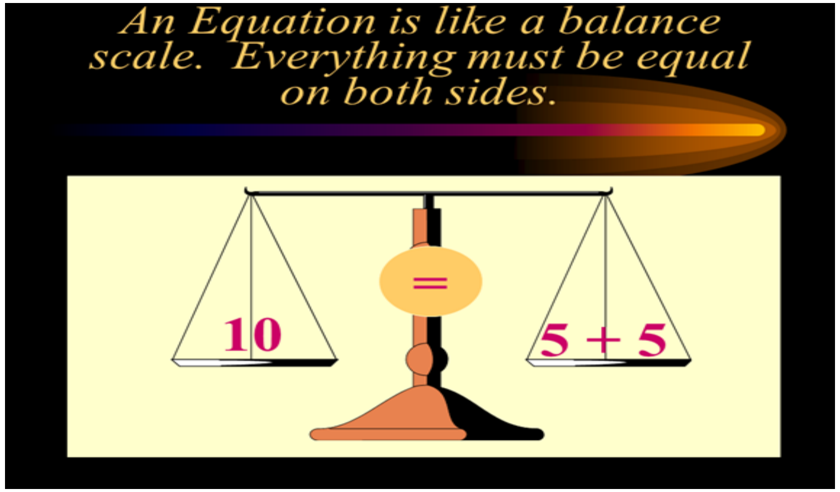
- Depicts the revenue and expenses for a designated period of time
- Net Income or net loss is simply the difference between revenues and expenses

Cash flow Statement

- Depicts the ways cash has changed during a designated period of time

Balance Sheet: Statement of Financial Position

- Presents financial position of an enterprise at specific point in time.
- Asset =Liabilities + Owners' Equity



- **Assets:** Economic Resources that are owned by the business and expected to provide future cash flow
- **Liabilities:** Debts that represent negative future cash flows for the enterprise
- **Owners' Equity:** Represents the owners' claim to the assets of the business

Balance Sheet: Statement of Financial Position

- It's a snapshot of the firm's assets and liabilities at a given point in time
- Assets are listed in order of liquidity
  - From least liquid to most liquid
  - Ease of conversion to cash without significant loss of value

SA Corporation Statement of Financial Position

As at December 31, 2011 and 2012
(R in millions)

	2011	2012		2011	2012
Equity and Liabilities			*Assets*		
Owners' equity			Non-current assets		
Share capital	R568	R640	Net plant & equipment	R1 644	R1 709
Retained profit	1 352	1 629			
Total equity	1 920	2 269	Current assets		
			Inventory	R553	R555
Non-current liabilities			Accounts receivable	455	688
Long-term debt	408	454	Cash	104	160
				R1 112	R1 403
Current liabilities					
Accounts payable	232	266			
Short-term debt	196	123			
	428	389			
Total equity and liabilities	R2 756	R3 112	Total assets	R2 756	R3 112

Income Statement

- More like a video of the firm's operations for a specified period of time.
- You generally report revenues first and then deduct any expenses for the period
- Matching principle –match the expenses required to generate the revenue

SA Corporation Income Statement

For the year ended 31 December 2012
(R in millions)

Sales		R1 509
Cost of sales		750
Depreciation		65
Profit before interest and tax (PBIT)		R694
Interest paid		70
Profit before tax (PBT)		R624
Taxes		244
Net profit after tax (NPAT)		R380
Dividends	R103	
Additions to retained profit	277	

The Concept of Cash Flow

- Cash flow is one of the most important pieces of information that a financial manager can derive from financial statements
- It deatils the ways cash has changed during a designated period of time
- It looks at how cash is generated from utilizing assets and how it is paid to those that finance the purchase of the assets

- Cash Flow From Assets (CFFA) = Cash Flow to Creditors + Cash Flow to Shareholders
- Cash Flow From Assets = Operating Cash Flow – Net Capital Spending – Changes in NWC
- This brings us back to the accounting equation:
- Asset =Liabilities + Owners' Equity

Cash Flow Summary: Sources and Uses

- **Statement that summarizes the sources and uses of cash**

- Sources
  - Cash inflow – occurs when we “sell” something
  - Decrease in asset account
    - Cash & equivalents is the only source
  - Increase in liability or equity account
    - Everything except accounts payable is a source
- Uses
  - Cash outflow – occurs when we “buy” something
  - Increase in asset account
    - Everything except cash & equivalents is a use
  - Decrease in liability or equity account
    - Accounts payable is the only use

Cash Flow Summary

I	**The cash flow identity**	
	Cash flow from assets =	Cash flow to lenders + Cash flow to shareholders
II	**Cash flow from assets**	
	Cash flow from assets =	Operating cash flow – Net capital spending – Additions to net operating working capital
	where:	
	Operating cash flow =	Profit before interest and taxes (PBIT) + Depreciation – Taxes
	Net capital spending =	Ending net non-current assets – Beginning net non-current assets + Depreciation
	Additions to net operating working capital =	Ending net operating working capital – Beginning operating net working capital
III	**Cash flow to lenders**	
	Cash flow to lenders =	Interest paid – Net new borrowing (short- and long-term)
IV	**Cash flow to shareholders**	
	Cash flow to shareholders =	Dividends paid – Net new equity raised

The Concept of Managerial Accounting (Costing) in the Financial Statement

- Costs refers to the amount of expenses incurred on a specific activity.

- For sales company
  - Costs incurred when buying a finished product
  - Cost incurred during sales

- In the income statement, the bulk of this cost is termed cost of sales (cost of goods sold)

Summary of Cost of Sales	Amount (Rand)	Amount (Rand)
Beginning Inventory		XXX
Purchases	XXX	
Freight-in	XXX	
Cost of Purchases	**XXX**	
Purchase discount	(XX)	
Returned good and allowances	(XX)	
Net Purchase		XXX
Cost of good available for sales		XXX
Ending Inventory		(XXX)
Cost of sales (cost of goods sold)		**XXX**

Concepts of Cost …Cont.

- For manufacturing company, its more complicated relative to sales company
  - Cost incurred during production

- When manufacturing something, costs usually incurred are as follows:

  a. Material costs – this is either:
    - **Direct material** – easily identified to the final product like wood for furniture and varies according to volume
    - **Indirect Material** – not easily identifiable to the final product but necessary like oil to run a machine to make the furniture and not variable according to volume (overheads)

  b. Labour:
    - **Direct Labour** – easily traceable to the final product like the cost of the carpenter to make the furniture and varies according to volume
    - **Indirect Labour** – not easily traceable to the final product like the wages of the storeman for the warehouse and does not usually vary according to volume (overheads)

  c. Expenses:
    - **Direct Expenses** - easily traceable to the final product other than the labour and material costs and varies according to volume
    - **Indirect Expenses** – not easily traceable to the final product and usually does not vary according to volume. Usually referred to as overheads

Concepts of Cost …Cont.

Summary of Cost of Sales of a manufacturing firm	Amount (Rand)	Amount (Rand)
Material (Beginning Inventory)		XXX
Purchases	XXX	
Freight-in	XXX	
Cost of Purchases	**XXX**	
Purchase discount	(XX)	
Returned good and allowances	(XX)	
Net Purchase (material)		XXX
Cost of material available for use		XXX
Material (ending Inventory)		(XXX)
Cost of material used		**XXXX**
Direct Labour	XX	
Prime cost: Fixed cost	XX	
Depreciation	XX	XXX
Total manufacturing cost		**XXXX**
WIP (opening Inventory)		XX
Cost of good to be manufactured		**XXXX**
WIP (closing Inventory		(XX)
Cost of goods manufactured		**XXXX**
Finished goods (Opening Inventory)		XXX
Cost of goods available for sale		**XXXX**
Finished goods (Closing Inventory)		(XXX)
Cost of sales (cost of goods sold)		**XXXX**

Types of Costs and their Behaviour Pattern

- **Fixed Costs** do not vary according to the volume produced. The per unit cost will increase or reduce based on volume, e.g. rent, salary of MD, etc.

- **Variable costs** vary directly in proportion to the volume you produce, e.g. direct material costs

- **Semi-variable costs** – contain both fixed and variable components – cost remains fixed up to a certain level of output and then increase variably above that –
  -

- **Semi-Fixed Costs** – also called stepped costs – remain constant for a certain volume and then increases and stays constant until the next threshold is reached.

SECTION B

Introduction to Finance (Corporate Finance)

Section B: Contents

- Introduction to Finance (Corporate Finance)
  - **Overview of Financial Management and Snapshot of Business**
    - Financial Manager’s Role
    - Shareholders and Stakeholders
    - Components of Financial Report (Statement)
  - **Basic Valuations of Business**
    - Time value of money
    - Present Value
    - Future Value
  - **Sourcing External Finance**
    - Overview Of Well-functioning Financial Market
    - When do Firms need external Finance
    - Popular financial contracts as external sources of funds for firms

Session 1

- **Overview of Financial Management and Snapshot of Business**
  - Financial Manager's Role
  - Shareholders and Stakeholders
  - Components of Financial Report (Statement)

The Role of Financial Manager

Capital budgeting

- What long-term investments or projects should the business take on?

Capital structure

- How should we pay for our assets?
- Should we use debt or equity?
  - Most SMEs go through short tem debt and angel financing

Working capital management

- How do we manage the day-to-day finances of the firm?
  - Working capital = current asset – current liabilities
  - Measure how effectively firms could pay off short term liability using current assets
  - It’s a liquidity measure

Shareholders and Stakeholders

- **Agency relationship**
  - Principals (Shareholders) hire agents (managers)
  - To represent their interest
  - To run the company
- **Agency problem**
  - Conflict of interest between principal and agent
- **Then comes Stakeholders’ interest**
  - Creditors
  - Customers
  - Suppliers
  - Community
  - Others

Examining Firm’s Financial Report

- **Standardized Financial Statements**

- Standardized statements make it easier to compare financial information, particularly as the company grows
- They are also useful for comparing companies of different sizes, particularly within the same industry

  - **Common-Size Statements of Financial Position**
    - Compute all accounts as a percent of total assets

  - **Common-Size Income Statements**
    - Compute all line items as a percent of sales

- Ratio Analysis
- Using Financial Statement Information

Examining Firm's Financial Report

- **Ratio Analysis**
  - Ratios also allow for better comparison through time or between companies
  - Ratios are used both internally and externally

- **Categories of Financial Ratios**
  - Profitability ratios
  - Short-term solvency or liquidity ratios
  - Long-term solvency or financial leverage ratios
  - Asset management or turnover ratios
- **Ratios:**
- Profitability ratios
  - Profit Margin = Net Profit after Tax / Sales
    - Profit margin is a measure of the firm's operating efficiency –
    - How well does a firm control costs
    - Efficiency of sales in generating profit
  - Gross profit margin = Gross profit/sales
  - Return on Assets (ROA) = Net Profit after Tax / Total Assets
  - Return on Equity (ROE) = Net Profit after Tax / Total Equity

Categories of Financial Ratios

- Short-term solvency or liquidity ratios
  - Current Ratio = CA / CL
  - Quick Ratio = (CA – Inventory) / CL
  - Cash Ratio = Cash / CL

- Long-term solvency or financial leverage ratios
  - Total Debt Ratio = (TA – TE) / TA
  - Debt/Equity = TD / TE
  - Equity Multiplier = TA / TE = 1 + D/E

- **Asset management or turnover ratios:**
  - Value of company's sales relative to its asset

- Total Asset Turnover = Sales / Total Assets
  - Total asset turnover is a measure of the firm's asset use efficiency –
  - How well does a firm manage its assets
- Fixed asset turnover = Sales / Fixed asset
  - Commonly used in manufacturing industries
  - Engaging in substantial purchases of PP&E in order to increase output.
  - Investments in fixed assets tend to represent the largest component of such company's total assets
  - Investors in such industry closely monitor fixed assets

Categories of Financial Ratios

- **Asset management or turnover ratios..cont**
- Cash turnover = Sales/cash
  - How cask balance is affected by firm's sales (positively)
  - How efficiently is cash flowing in the business due to sales

- Inventory Ratios
  - Inventory Turnover = Cost of Goods Sold /Inventory
  - Days’ Sales in Inventory = Inventory / Cost of goods Sold x 365
    - Measures how long it takes a firm to sale off inventory

- Receivables Ratios
  - Receivables Turnover = Sales / Accounts Receivable
  - Days’ Sales in Receivables = AR/Credit sales x 365
    - Measure how long it takes affirm to collect debt after sales is made on credit

Revenue Vs Turnover

- Sometimes Revenue and Turnover can be used interchangeably
- Sometimes can mean the same.
- E.g. Assets/inventory are turned over when used in business
  - Either by sale of such assets or
  - They outlive their useful lives.
- Income generated by sale of such assets is referred to as revenue.
- But in general especially in accounting and business:
  - Revenue and turnover are two different terms

Revenue Vs Turnover

- Revenue
  - Money earned through sales of the goods and services
  - Affects firm's profit
  - Determines firm growth
  - Mandatory report in financial statements

- Turnover
  - How efficient a firm is through assets utilization
  - Affects efficiency
  - Determines efficiency use of assets
  - Not mandatory, but can use used by investors for investment decision

Benchmarking

- **Ratios are not very helpful by themselves; they need to be compared to something**
- **Time-Trend Analysis**
  - Used to see how the firm’s performance is changing through time
  - Internal and external uses
- **Peer Group Analysis**
  - Compare to similar companies or within industries

Session 2

- **Basic Valuations of Business**
  - Concept of Time value of money
  - Present Value
  - Future Value

Concept of Time Value of Money

- **Money in hand now is worth more than money promised in future**
- **Because if invested:**
  - Interest is earned on the principal
  - Interest is earned on interest capitalised interest
  - Reward (trade-off) of forgoing the use of money now is the interest earned

- **The trade-off depends on:**
  - The rate of interest (r) (comes time referred to as cost of capital
  - The duration of the investment (t)
  - And sometimes the economic situation (inflation rate)

Present Value

- **Present Value = earlier money on a time line**
- **How much do I have to invest today to have some amount in the future?**
  - **$PV = FV / (1 + r)^t$**

- **we mean finding the present value of some future amount.**
  - PV = present value
  - FV = future value
  - r = period interest rate, expressed as a %
  - t = number of periods
- **Interest factor = $(1 + r)^t$**

Future Value

- **Future Value = later money on a time line**

- **If I invest some amount today, how much will I get in future?**
  - **$FV = PV (1 + r)^t$**

- **We mean finding the future value of some present amount.**

Simple Vs Compound Interest

- **Both present and future value make use of compound interest calculation**
  - where the interest generated in the previous year is discounted and capitalised

- **Suppose you invest R1000 for one year at 5% per year. What is the future value?**
  - Interest = 1000(0,05) = 50
  - Value = principal + interest = 1000 + 50 = 1050
  - Recall $\Rightarrow$ Future Value **(FV) = PV(1 + r)^{t}** = 1000(1,05) =1050

- **Suppose you leave the money in for another year. How much will you have?**
  - FV = $1000(1,05)^2$ = 1000(1,05)(1,05) = 1102,50

  - FV with simple interest = 1000 + 50 + 50 = 1100 for two years
  - FV with compound interest = **FV = $1000(1 + 0,05)^2$** 1102,50 for two years
  - The extra 2,50 comes from the interest of 0,05 earned on the first interest payment i.e.. 0,05(50) = 2,50

- **For three years**
  - FV with simple interest = 1000 + 50 + 50+50 = 1150 for three years
  - FV with compound interest: **FV = $1000(1 + 0,05)^3$** = 1157,625 for three years

Capital budgeting

- Ascertaining extent investment with a long-term lives will impact a business
  - Aids decision making process
    - Innovation projects
    - Value addition

- Capital budgetary tools
  - Payback Period
  - Net Present Value--NPV
  - Internal Rate of Return--IRR

Payback period

- **Measures how it take to get the initial cost back in a nominal sense?**
- **Computation:**
  - Estimate the cash flows
  - Subtract the future cash flows from the initial cost until the initial investment has been recovered
- **Decision Rule –** ***Accept if the payback period is less***

- **Advantages:**
  - Easy to understand
  - Adjusts for uncertainty of later cash flows
  - Biased towards liquidity
  - Better for short term projects

- **Disadvantages:**
  - Ignores the time value of money
  - Requires an arbitrary cutoff point
  - Ignores cash flows beyond the cutoff date
  - Biased against long-term projects, such as research and development, and new projects

Net Present Value (NPV)

- Measures difference between the market value of a project and its cost
- **Computation:**
  - Estimate the expected future cash flows.
  - Estimate the required return for projects of this risk level.
  - Find the present value of the cash flows and subtract the initial investment.

- If the NPV is positive, accept the project
- A positive NPV means
  - Project is expected to add value to the firm
  - Therefore will increase owners' wealth
  - **NPV = CF / (1 + r)^t-I**
    - CF=Cash flows
    - I =Initial investment
    - r= Interest rate
    - t= time

Net Present Value (NPV)

- Accounts for the time value of money
- Accounts for the risk of the cash flows
  - By considering the time value of money
- Provides an indication about the increase or reduction in value

Internal Rate of Return (IRR)

- Alternative to NPV
- Independent of interest rates found elsewhere
- Determine the rate of return where NPV is Zero
- Based entirely on the estimated cash flows

- **Decision Rule:** *Accept the project if the IRR is greater than the required return*
- **Disadvantages:**
  - Could give conflicting results
    - Non-conventional cash flows – cash flow signs change more than once

Session 3

- **Sourcing External Finance**
  - Overview Of Well-functioning Financial Market
  - When do Firms need external Finance
  - Popular financial contracts as external sources of funds for firms

Overview of Financial Market

- **Financial market**
  - Like any other market, brings buyers and sellers together
  - Debts equity securities are bought and sold

Money Mkt Vs Capital Mkt

Money Mkt	Capital Mkt
Short term	**Long term**
Bankers' acceptance	Shares
Treasury bills	Bonds

Participants

Money Mkt	Capital Mkt
Banks	Banks
Other financial institutions	Companies
Large companies	Governments

Primary Mkt Vs Secondary Mkt

Primary Mkt	Secondary Mkt
Original buying/selling	For subsequent buying/selling
Public offering/	Owner/lender selling to another
Private placement	Transfer of ownership

- **JSE is the largest Stock (capital) Market in Africa**

External Finance

- **Any fund sourced outside the company's internal sources of fund**
    - Short or Long term sources

- **Examples**
    - Credit Purchases
    - Bank Loans
    - Venture capital
    - Issuance of Equity
    - Issuance of Bond

- **Advantages**
    - Helps preserve internal earnings (could be invested in more earning assets)
    - Facilitates growth

- **Disadvantages**
    - Ownership
    - Payment of interest or dividends

Venture capital –Angel Investors-Private equity

- Financing investors provide to startup companies
  - Believed to have long-term growth potential.

- Venture capital could come from
  - Well-off investors
  - Investment banks and
  - Other financial institutions.

- May not necessarily be in monetary terms
  - In the form of technical
  - In the form of managerial expertise.

- It can be provided at different stages of their evolution
- Might be provided by a pool of investors

Venture capital –Angel Investors-Private equity

- Venture capital can be risky for investors
  - But has potential for high returns
  - And an attractive payoff
- Venture capital funding is increasingly becoming:
  - Popular
  - Essential – source for raising capital,
- Especially for firms that lack access to:
  - Capital markets,
  - Bank loans or
  - Other debt instruments.
- Downside
  - Venture capitalist influence the decision making of the firms invested in

Venture capital –Angel Investors-Private equity

- **<u>Attractions to venture capitalists</u>**
- Companies that are well-managed
- With well developed business plan/budget
- Potential for growth
- Potential for sustainability
- Firms in same or similar industry
- Or familiar industries/ business sectors
- Where trusted fellow venture capitalist or angel invested has invested in

Popular External Financing Contracts

- **Equity Contract**
- **Equity/Stock/Shares**
  - Ordinary shares
  - Preference shares
  - Derivatives
    - Futures
    - Options

- **Debt Contract**
- **Bonds**
  - Government bonds
  - Zero Coupon bonds
  - Floating-Rate Bonds
  - Securitized Bonds
  - International bonds

Section C

Introduction to Business Budget

Business Budget

- Business Budgeting is:
  - Mapping the present
  - Forecasting the future
- A company’s budget is usually
  - An internal planning document
  - Prepared for a specific time period,
    - Month, Quarter, or Year, and
  - Stating firm’s anticipated revenue and expenses
  - For the specified period.
- To ensure
  - Liquidity
  - Sustainability
  - Performance
- Budgeting allows for the evaluation of firm’ performance
  - Even during planning period

Business Budget

- Every business needs a budget
  - Small
  - Medium
  - Large
- For good financial management
  - Most venture and small businesses do not operate with budget
- Even if they do, it’s always for
  - Business plan
  - Bank loan
  - Angel investors/venture capitals
  - And discarded afterwards

Business Budget

- New Entrepreneurs
  - Usually assume busy and do not want to spend time on budget
- Instead focus on
  - Marketing product and services
  - Seeking contracts
  - Business expansion
- Thereby
  - Avoid attention to financial details,
    - Mistakes creep in
    - In turn exposes business to failure

Working Budget

- Every business needs working budget
  - Its working budget because
  - It is a work in progress.
  - The owner refers to it
  - Consults it
  - Applies it
  - Makes adjustments regularly .
- Working budget is a business game plan.
- A working budget is required from business inception
  - Ideas cannot be conceptualized with out working budget
  - Ideas cannot be materialized with out working budget
  - It accesses health (financial) of the business
  - It helps to expose potential opportunities
  - Exposes potential pitfalls

Budget Vs Strategic Plans

- Every aspect of life needs plan,
  - Including establishment of new businesses
  - and management/ sustainability of existing businesses

- A strategic plan
  - Views all aspects of what the business could do
  - Narrows it down to what the business is actually good at doing.
  - Helps business leaders determine where to spend:
    - Time
    - Human capital,
    - And financial capital.

- Strategic planning process might seem devastating
  - If appropriate steps are applied
    - It’s easy to break through.
    - Business processes become easier

Steps/Approaches of Strategic Planning

- **1. Determine your business position.**
  - Form an accurate picture of your business position
  - Conduct external and internal reviews to clearly understand of
    - The marketplace
    - The products
    - The customers
    - The environment
    - The competitors
    - Your organization’s SWOT
      - Strengths
      - Weaknesses
      - Opportunities
      - Threat
        - Real, not perceived SWOT.

Steps/Approaches of Strategic Planning

- **2. Identify core and important issues.**
  - Focus on the business future (long term)
  - Set direction of the business over the long term
  - Define the business mission and targets
    - Products, markets, customers, etc.
  - Define the business vision
    - Conceptualise the business future

- **3. Set business objectives.**
  - Define business objectives
  - Objective must be SMART
    - Specific
    - Measurable
    - Attainable
    - Relevant
    - Time-Based
  - Set priorities
  - Focus on long term achievements/sustainability.

Steps/Approaches of Strategic Planning

- **4. Set responsibilities and accountability.**
- Communicate effectively how to and/or who will
  - Allocate time,
  - Allocate human capital,
  - Allocate financial capital
  - Address the priority issues and
  - All focused on the defined objectives

- **5. Review the steps/approaches.**
  - Regularly review processes
  - Redefine process and schedules if necessary
    - Monthly/ quarterly /annually

Steps/Approaches of Strategic Planning

Business Position
- Define the business position
- Solidify the unique position
- Identify market opportunities
- Determine strength and weaknesses
- Summarise the SWOT items

Core Important Issues
- Identify strategic core issues to address
- Identify key business beliefs
- Create a mid-term image of business success
- Develop a mid-term financial projections
- Establish approaches on how to succeed
- Process the SWOT to help in setting priorities

Business Objectives
- Determine the core business purpose/objective
- Identify short-to-mid term SMART goals
- Identify long-term SMART goals
- Set Priorities
- Focus on long term achievements/ sustainability

Responsibilities and Accountability
- Align a one year budget with the plan
- Assign the organisational goals to departments
- Assign departmental goals to individuals
- Allocate time to the plan
- Select key indicators to track progress

Review
- Communicate strategy to the entire organisation
- Establish schedule for progress review
- Train employees to use strategic plan
- Progress reviews and amend/modify
- Review year end plan, plan for next year

Advantages of Strategic Planning

- It helps facilitate business (especially small businesses)
    - Performance
    - Growth
    - Sustainability

- It helps keep business on track
- It helps keep business focused on the future.

- Prior to budget, firms put up strategic plans
    - For specific number of years
    - Strategic plans inform the budgetary plan
    - Determines the type and basis of budget to embark on

Types of Budget

- Companies have various types and sub types of budget
- **Master Budget**
  - Depends on the size of business:
  - A comprehensive budget plan
  - Usually a one year-budget document for the business,
  - Comprising all other sub-budgets
  - Maybe broken down in weeks/ months/quarter
  - Always in line with the firm’s financial year
  - Could be rolled over from year to year if appropriate for the firm
    - This is called continuous budget
- It’s usually of two parts
  - The operating budget and
  - The financial budget

Operating Budget

- Depending on the size and nature of the business
- Operating budget states income generating activities of a firm
- Including
  - Revenue
  - Expenses

- Sometimes could be referred to as budgeted income statement
- Operating budgets are prepared first
  - Information from it is needed for the financial budgets.

- Operating budget is comprised of eight interrelated budget planning schedules.
- They interrelate to develop a budgeted income statement based on the nature of the business

Operating budget planning schedule

- Sales budget, which is based on the sales forecast.
  - Not usually the same as sales forecast
  - Is adjusted based on managerial judgment and
  - other data
    - Market conditions
    - Competitors
    - Customers

- Production budget.
  - After budgeted sales
  - Followed is how many production, in units the company has to make in order to
    - Meet the sales budget
    - Meet-ending inventory requirements.
    - Most companies have an ending inventory they want to meet every month / quarter/year
    - Avoid excess stock or out of stock.

- Direct materials purchases budget
  - Budgets for the raw materials the firm uses in its production process,

- Direct labor budget

Operating budget planning schedule

- overhead budget.
  - Including fixed and variable overhead costs.

- Ending finished goods (inventory) budget is necessary to complete:
  - Cost of goods sold and
  - Balance sheet
  - It assigns a value to every unit of product produced based on
    - Raw materials,
    - Direct labor, and
    - Overhead.

- Cost of goods sold budget
- The selling and administrative expense budget
  - Connects to non-manufacturing costs such as freight or supplies.

- The result of the eight budget schedules above is the budgeted income statement

Financial budget

- Financial budget:
- Facilitate financial planning and control within a firm
- Helps to financial aspects of business and
- Plan for new product expansion in the future.
- Financial budget consists of
  - Firm’s cash receipts and payments
  - Firm’s cash inflows and outflows
  - Other elements of the firm's financial position.

- Cash inflows and outflows come from cash budget
- Therefore, the result of the financial budget is the budgeted balance sheet

- Cash receipts consists of:
  - Cash received from customers,
    - Including receipts from credit sales.
  - Cash disbursements are pay-outs to vendors.

Financial budget planning schedule

- Three budgets are found in financial budget part of the **master budget**.
- Cash budget (usually on a monthly basis)
  - Cash inflows and outflows,
  - Expected borrowing, and
  - Expected to invest
  - Non cash items are excluded from cash budget.
- Budgeted balance sheet: gives the ending balances of the firm's
  - Asset,
  - Liability
  - Equity accounts
- Budget for capital expenditures.
  - Budgetary figures for firm’s large and expensive fixed assets

- These are the most often used budgets within the master budget of business firms.
- Note: Note all firms will use all the budgets, depending in nature of business
  - Service firms may not use production budgets.

Static budget

- The static budget
- Apportions fixed monetary amounts on a budget
  - That are decided upon before the budgetary period begins.
  - It presents revenue and expenses based on projections.
  - A budget that is always static is overhead budget
    - Fixed expenses incurred a firm that doesn’t change with revenue or expenses.
    - Examples:
    - Rent
    - Utilities
    - Some administrative costs
    - Loan repayment
- Static budget could be through
  - A mark-up from previous budget (%)
  - Projected inflation

Pros and cons of Static budget

- **Pros:**
- Easy to use
  - Can be used by inexperienced manager/small business
- It allows putting a cap on a spending limit
- It allows firms to tie certain resources to particular output
- It could server as a base for a budgetary period
- Serves as a starting point at the beginning of a budgetary period
- Can easily be combined with flexible budget

Pros and cons of Static budget

- **Cons:**
- Its static, does not change…while revenue and costs are dynamic.
  - If revenues drop, firms cannot allocate more resources to improve revenue.
  - If revenues increase, resources cannot be moved to an underperforming line item.
  - Problematic for most firms,
    - Unless the firm has stable revenue and expenses, such as a utility company.
  - Utilities can use static budgets more effectively than most companies.

- It usually relies on current data.

Flexible Budget

- Dynamic budget where figures are adjusted based on events and factors
    - Allows firm to adjust revenue based on expenses and existing factors
    - Allows costs to be adjusted based on sales volume
    - Gives managers better financial control of the firm
    - Tends to be more accurate than static budgets.
    - Very good for firm evaluation at the end of budgetary period

Steps for Business Budget

- 1. Table firm’s Sources of income
- 2. Identify Fixed Costs
- 3. Include Variable costs
- 4. Predict One-Time Spending
- 5. Pull It All Together

- First four steps detail the features of a good business budget,
- Fifth step is simply a review and implementation

Some components of Budget

- Sales and revenues –
  - These are budget cornerstone
  - Every other budget depends on these
  - Best basis for estimated sales/revenue is from previous year
  - New businesses will depend on research/experience from previous jobs
- Sources of revenue
  - Earnings
  - Product Sales
  - Investment Income
  - Loans
  - Savings
  - Other

Some components of Budget

- Total costs and expenses
  - These can be difficult as they depend on economic situation and other factors
- Costs can be divided into categories:
- Fixed costs --Static costs
  - Rent/Mortgage/insurance
  - Utilities
  - Loan repayment
  - Salaries (sometimes)
  - Internet
  - Government and bank fees
  - Cell phone
  - Website hosting
  - Legal services

Some components of Budget

- Variable costs –Dynamic, moves with production and sales volume
  - Raw Materials
  - Contractor Wages
  - Commissions
  - Advertising
  - Other Marketing Costs
  - Transportation
  - Travel & events
  - Printing Services, etc.

- Semi-variable costs.
  - Fixed cost that can be dynamic due to volume of business—
  - Salaries,
  - Communications,
  - Advertising etc.

Some components of Budget

- One-time Spending:
  - Purchase of fixed assets
    - Computer
    - Furniture
    - Vehicles
    - Buildings
- Software
- Office Supplies
- Gifts

Pros of budget

- Helps plan for eventualities.
- Could reveal areas for cost savings
- Enables sort out priorities
- Helps find the right balance between spending and saving.
- For better planning
- Helps minimize business risk
- Reveals possibilities/challenges
  - Possibility of new start-up
  - Accurate estimation of profit
- Helps adjust plans and expectations
- Helps troubleshoot, if target is not being met

CATEGORY	BUDGET AMOUNT	ACTUAL AMOUNT	DIFFERENCE
Sales Revenue			
Interest Income			
Investment Income			
Other Income			
TOTAL INCOME			
EXPENSES			
Accounting Services			
Advertising			
Bank Service Charges			
Credit Card Fees			
Delivery Charges			
Deposits for Utilities			
Estimated Taxes			
Health Insurance			
Hiring Costs			
Installation/Repair of Equipment			
Interest on Debt			
Inventory Purchases			
Legal Expenses			
Licenses/Permits			
Loan Payments			
Office Supplies			
Payroll			
Payroll Taxes			
Printing			
Professional Fees			
Rent/Lease Payments			
Retirement Contributions			
Subscriptions and Dues			
Utilities and Telephone			
Vehicle Expenses			
Other			
Other			
TOTAL EXPENSES			
TOTAL INCOME MINUS TOTAL EXPENSES			

Business Budget Template

Business Budget

[Company Name]

INCOME	Actual	% of TS	Budget	% of TS	Difference
Sales					
Product 1		-		-	-
Product 2		-		-	-
Product 3		-		-	-
Product 4		-		-	-
Product 5		-		-	-
Product 6		-		-	-
Other		-		-	-
Total Sales (TS)	-	-		-	-
Cost of Goods Sold (from details section)					
COGS - Product 1	-	-		-	-
COGS - Product 2	-	-		-	-
COGS - Product 3	-	-		-	-
COGS - Product 4	-	-		-	-
COGS - Product 5	-	-		-	-
COGS - Product 6	-	-		-	-
Total Cost of Goods Sold	-	-		-	-
Gross Profit	-	-		-	-
Non-Operating Income					
Interest Income					-
Rental Income					-
Gifts Received					-
Donations					-
Other					-
Total Non-Operating Income	-				-
Total INCOME	-				-

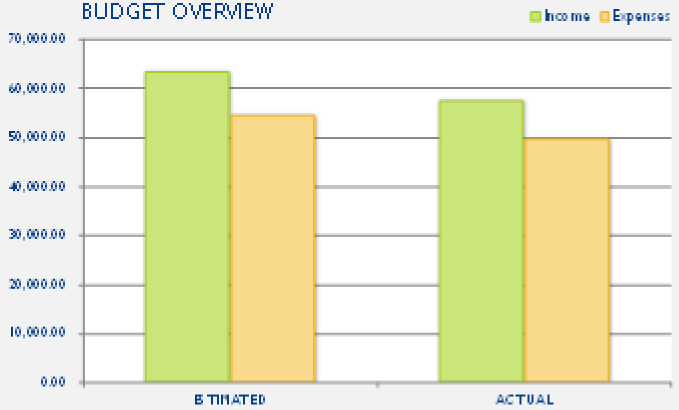
COMPANY NAME

MONTHLY BUSINESS BUDGET

March 2017

BUDGET TOTALS	ESTIMATED	ACTUAL	DIFFERENCE
Income	63,300.00	57,450.00	(5,850.00)
Expenses	54,500.00	49,630.00	4,870.00
Balance (Income minus Expenses	8,800.00	7,820.00	(980.00)

BUDGET OVERVIEW



WHAT ARE MY TOP 5 HIGHEST OPERATING EXPENSES?

EXPENSE	AMOUNT	% OF EXPENSES	15% REDUCTION
Maintenance and repairs	4,600.00	9.3%	690.00
Supplies	4,500.00	9.1%	675.00
Rent or mortgage	4,500.00	9.1%	675.00
Taxes	3,200.00	6.4%	480.00
Advertising	2,500.00	5.0%	375.00
Total	19,300.00	38.9%	2,895.00

INCOME	ESTIMATED	ACTUAL	DIFFERENCE
Net sales	60,000.00	54,000.00	(6,000.00)
Interest income	3,000.00	3,000.00	0.00
Asset sales (gain/loss)	300.00	450.00	150.00
Total	63,300.00	57,450.00	(5,850.00)

PERSONNEL EXPENSES	ESTIMATED	ACTUAL	DIFFERENCE
Wages	3,500.00	3,600.00	(100.00)
Employee benefits	4,000.00		4,000.00
Commission	5,000.00	4,500.00	500.00
Total Personnel	18,500.00	14,100.00	4,400.00

OPERATING EXPENSES	ESTIMATED	ACTUAL	DIFFERENCE
Advertising	3,000.00	2,500.00	500.00
Bad debts	2,000.00	2,000.00	0.00
Cash discounts	1,500.00	2,175.00	(675.00)
Delivery costs	2,000.00	1,500.00	500.00
Depreciation	1,000.00	1,000.00	0.00
Dues and subscriptions	500.00	525.00	(25.00)
Insurance	1,300.00	1,275.00	25.00
Interest	2,000.00	2,200.00	(200.00)
Legal and auditing	1,000.00	800.00	200.00
Maintenance and repairs	4,500.00	4,600.00	(100.00)
Office supplies	800.00	750.00	50.00
Postage	400.00	350.00	50.00
Rent or mortgage	4,100.00	4,500.00	(400.00)
Sales expenses	350.00	400.00	(50.00)
Shipping and storage	900.00	840.00	60.00
Supplies	5,000.00	4,500.00	500.00
Taxes	3,000.00	3,200.00	(200.00)
Telephone	250.00	280.00	(30.00)
Utilities	1,400.00	1,385.00	15.00
Other	1,000.00	750.00	250.00
Total Operating	36,000.00	35,530.00	470.00

Centre for Enterprise Sustainability

Efficiency Through Sustainability

THANK YOU

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