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Financial Planning and Analysis (FP&A)

Course Notes

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Section 1: Getting Started with Financial Planning & Analysis

1.1. What is a Budget and Why Do We Need It?

Budgeting is the process of creating a plan for a firm's or individual's resource allocation.

<u>How do budgets help companies?</u>

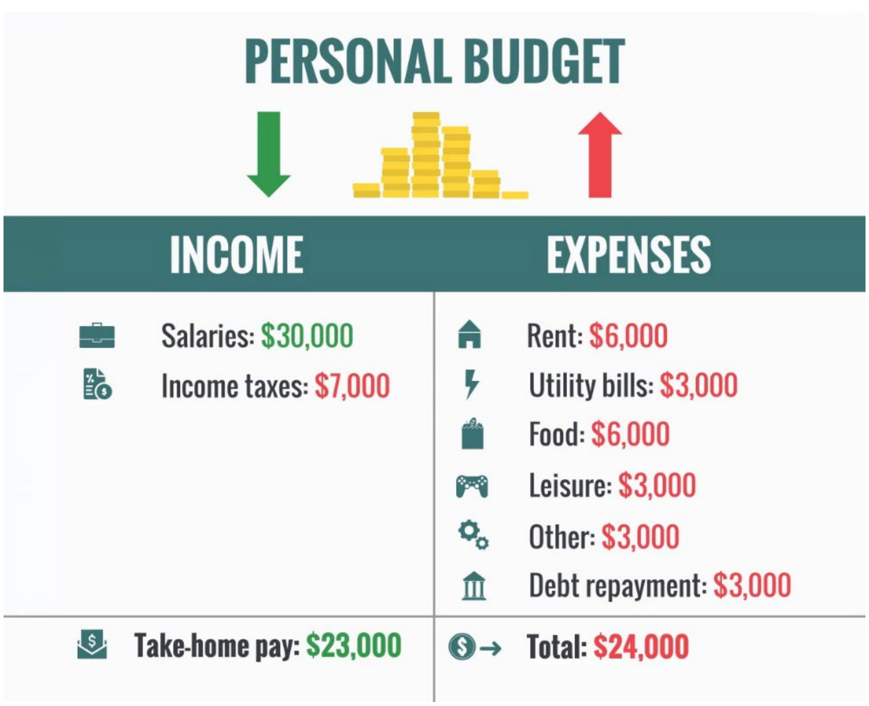
Corporate budgets are an effective tool that guides companies toward achieving their objectives. Without a plan, an organization runs the risk of losing sight of the big picture and its strategic goals. That's one of the primary reasons why companies prepare budgets. Planning, or budgeting, in particular, is an essential part of corporate finance and a key tool for any firm that wants to stay competitive in the market.

The Budget contains the goals set for the upcoming years. More importantly, it includes a detailed plan of how to achieve these goals. Planning identifies potential opportunities and bottlenecks in advance and assists management in decision-making.

<u>How do budgets help individuals?</u>

Personal budgets contain a list of an individual's expected income and expenses. They help set up financial goals for the upcoming years and find ways to achieve the desired outcomes.

An example of a personal budget template:



Section 2: The Accounting Framework

2.1. The Three Financial Statements that are the Backbone of Any Company's Budget

A company's Budget is a detailed roadmap showing the financial results to be achieved.

Such a detailed plan of action is expressed through the three main financial statements:

- Income Statement (Profit & Loss Statement)
- Balance Sheet (Statement of Financial Position)
- Cash Flow Statement

2.2. Understanding the Income Statement

Income Statement	
Revenue	**X**
Cost of goods sold (COGS)	(X)
Gross profit	**X**
Operating expenses	(X)
EBITDA	**X**
Depreciation & amortization	(X)
Operating profit (EBIT)	**X**
Interest expenses	(X)
EBT	**X**
Tax expenses	(X)
Net Income	**X**

The Income Statement helps us understand whether the operations of the firm created economic value or not. It contains the following items:

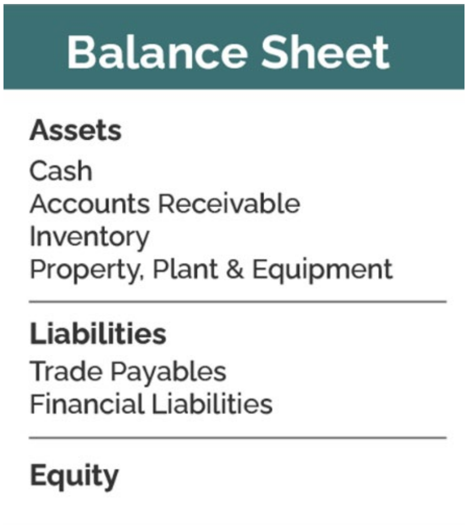
Revenue – The P&L's top line. The sales that the company is expected to make in the given year.

Cost of Goods Sold (COGS) – This line identifies how much it will cost to produce the goods to be sold.

Selling, General & Administrative expenses (SG&A) – This includes advertising and promotions, salaries of management & personnel not involved in the production process; rent for offices, and utility bills such as electricity, phone, and water bills.

Depreciation & Amortization (D&A) – The "using up" of tangible and intangible assets

2.3. Understanding the Balance Sheet



A Balance Sheet is a statement that shows what the company owns (assets) and what it owes (liabilities and equity). It contains the following items:

<u>Assets</u>

Cash – This is the money available in the company's bank account.

Accounts Receivable – When customers buy a firm's products, they have to pay for them. And until they do, the firm will register the amount due in accounts receivable.

Inventory – This is the account that shows the value of raw materials, goods that are in the process of elaboration, and finished goods that are ready to be sold to customers.

Property, Plant & Equipment (PP&E) – These are tangible assets that are used in the production process.

<u>Liabilities</u>

Trade Payables – When a company buys raw materials for its production process, it records the amount in Accounts Payable until the actual payment has been made. The firm owes its supplier a given amount of money because it received the goods.

Financial Liabilities – This line summarizes the external financing that the company has to repay on top of interest.

<u>Equity</u>

Equity is also known as "ownership claims". This is the capital that a firm technically "owes" to its owners. Standard equity components include:

- Common shares
- Preference shares
- Paid-in capital
- Retained earnings

2.4.1. Cash vs. Profit?

Profit is an accounting concept; it is calculated as Revenue minus Expenses in a company's *Income* Statement:

Profit = Revenue – Expenses

However, the profit figure is not the only key indicator of business performance. An integral part of a firm's financial well-being is its cash flow position.

Net Cash Flow recognizes all the actual inflows and outflows of cash that occur during a given period.

Net Cash Flow is a liquidity indicator that can be found in a company's *Cash Flow Statement*.

Many firms fail to recognize the difference between profitability and liquidity and in doing so, expose themselves to huge risks. The performance and prospects of companies practically rely on their ability to balance accounting profits and the available cash at hand.

2.4.2. Understanding the Cash Flow Statement

The Cash Flow Statement is a report showing the cash inflows and outflows that a company generates. It contains the following sections:

Cash Flows from Operating Activities – result from transactions that affect a firm's Net Income.

This section shows whether, and to what extent, companies generate cash from their core operations:

- Cash receipts from the sale of goods and the rendering of services
- Cash payments to suppliers for goods and services
- Cash payments to and on behalf of employees

Cash Flows from Investing Activities – result from investment (not operating) transactions; this section tells us the extent to which new investment in assets will generate future cash flows. It includes:

- Investments in or proceeds from the sale of tangible and intangible assets
- Cash receipts from sales or cash payments to acquire financial instruments issued by other enterprises

Cash Flows from Financing Activities - result from cash transactions that affect a company's capital structure:

- Cash proceeds from the issuance of new shares
- Cash payments to stockholders to redeem shares or repay borrowings
- Cash dividends paid
- Cash proceeds from the issuance of bonds, loans, notes, and other short-and long-term borrowings

2.4.3. Direct vs. Indirect Method

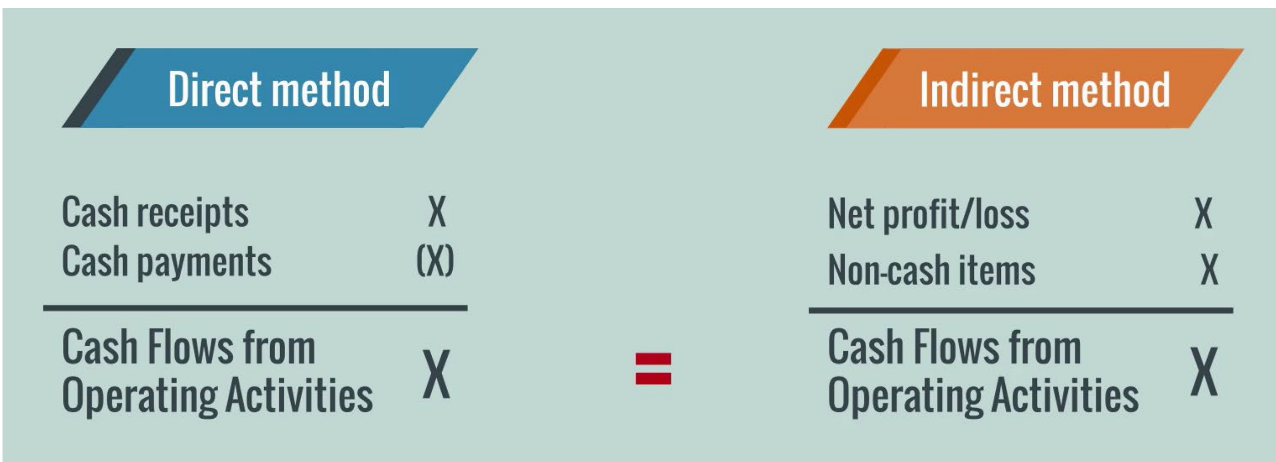
Cash Flows from Operating Activities can be calculated using two different methods:

Direct method - discloses major classes of gross cash receipts and cash payments. It is based on bank account movements and summarizes all cash transactions that a company makes throughout the reporting period.

Indirect method - deals with Net Income and non-cash adjustments.

Net profit or loss from the Income Statement is adjusted for the effect of non-cash transactions. Such adjustments include eliminating any deferrals or accruals, non-cash expenses (i.e. depreciation and amortization), and any non-operating gains and losses.

Net Cash Flow from Operating Activities remains the same, no matter which method you use. It is just derived differently.



2.5. How Are the Three Financial Statements Interrelated?

The amounts in a firm's Cash Flow Statement derive from changes in the Income Statement and Balance Sheet. There are some general dependencies you should bear in mind when analyzing or budgeting the financial statements of an entity.

Cash Flows from Operating Activities (CFO) – to calculate it (using the Indirect Method) you will need to refer to the firm's Balance Sheet and calculate changes in some *current assets*:

- Accounts receivable
- Accounts payables
- Inventory

Cash Flows from Investing Activities (CFI) - refer to changes in a firm's *non-current assets* on the Balance Sheet:

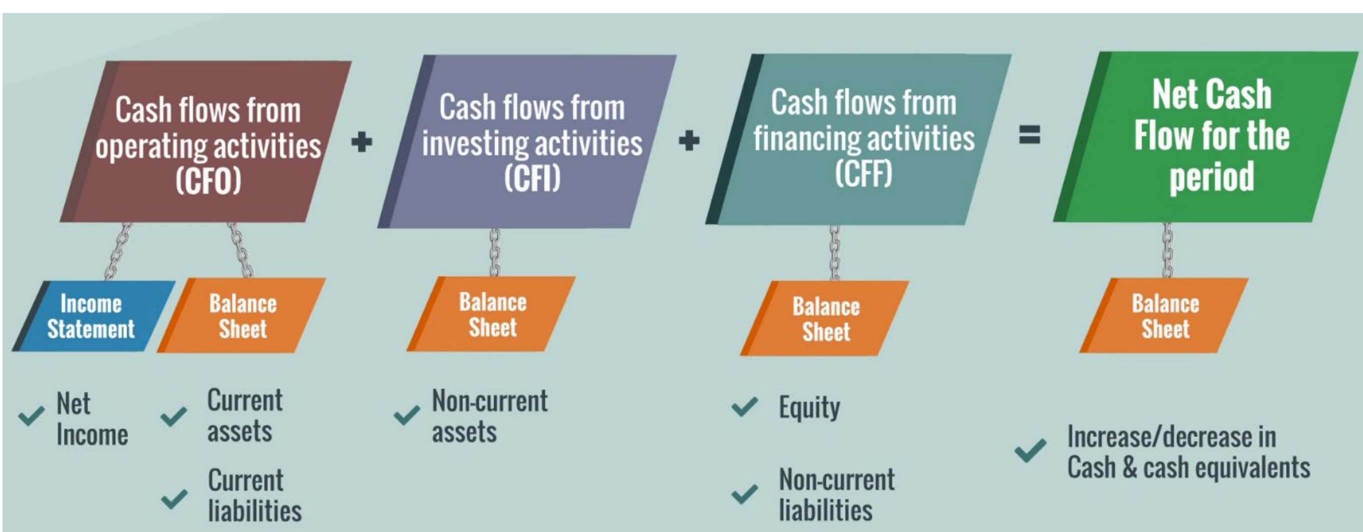
- Property, Plant, and Equipment (PP&E)
- Accumulated depreciation

Cash Flows from Financing Activities (CFF) - refer to a company's sources of finance. To calculate it, you need to evaluate the changes in the *Equity* or *Non-current liabilities* sections in the Balance Sheet:

- Share capital
- Dividends paid
- Long-term loans

N.B.

CFO + CFI + CFF = Net change in Cash and cash equivalents



Section 3: Mechanics of the Budgeting Process

3.1. Benefits of Budgeting

The **Budget** is an organization's operational plan for the future. It illustrates the firm's estimation of expected revenue and expenses, as well as the inflow of resources and their allocation.

Having a rigorous budgeting process benefits companies in many ways:

- It **helps organizations outline what they want to achieve** in the near and distant future. The Budget translates the corporate strategy of companies into specific objectives. We can say that budgeting is the tactical implementation of a firm's strategic goals. Put differently, it's their plan for the future, formalized in quantitative terms.

- It **defines operational targets**. In the Annual Business Plan of an organization, you can find the predicted sales growth %, the planned net profit figure, as well as the cash flows that the company expects to generate.

Targets must be ambitious, yet achievable.

Setting goals that are a bit higher than historical performance leaves room for improvement. In this way, the Budget motivates managers to put their best efforts toward achieving the company's financial goals.

However, too high or too low target levels may be quite demotivating for most employees. Ideally, the Budget is a tool that allows firms to assess whether they are doing better or worse than expected. It is a reality check, a guiding light that provides a sense of accountability and a desire to reach the set targets.

- Budgeting also serves as a **controlling tool**. Department managers usually compare the actual performance with the budgeted one. It is the Budget itself that helps department heads stay on track with their spending. Managers normally disapprove of any costs that exceed the targeted amount as per the ABP. In times of economic slowdown, companies would typically impose tight budgets, so that they minimize expenses and make it possible to drive the organization through the recession.

- It is used as a **means of communication**. Through the Budget, companies communicate their goals and objectives to department managers and employees. In this way, everyone gets a clear understanding of their role and contribution to the overall mission of the organization.

3.2. Key Steps of Budget Preparation

To complete the Budget of an organization one needs to understand its current operations in detail, so they can set proper goals for the future. It essentially involves the coordination of finance and non-finance objectives and efficient communication across the whole organization. Whatever the business specifics, though, every Budget preparation process goes through several key steps:

1. **Define major goals and objectives**

These are the quantitative expectations of the company's future performance. Let's say that a firm aims at a 5% growth in profitability for the next year. How does it achieve that? Does it expect higher sales? Will cost reduction do the trick instead? Answering these questions requires the company to prepare a detailed Budget, breaking down the overall objective into smaller targets.

2. Gather data

It is the department heads that provide their estimates and assumptions on the expected sales, production levels, availability of resources, planned restructuring, and so on. Every department or sub-structure in the organization comes up with their own plan.

3. Prepare the model

Next, department managers pass the information over to the Budget Committee that compiles all the information available and prepares the budget model. This is a group of people (usually, members of the finance team) who maintain the overall responsibility of the budgeting process.

The Budget Committee might need to do some adjustments to synchronize the views of all the individual units. For instance, if the HR department and the Production department set different priorities, these should be aligned. Once settled, the Budget Committee approves the final Budget.

4. Communicate the Budget

Upon approval, the Budget should be clearly communicated to department managers. Sales Managers are primarily responsible for implementing the Sales Budget, so they need to be aware of the specific changes in revenue targets for next year. Production managers should know the approved production levels and plan their resources accordingly. It's a whole process that thrives on teamwork and cooperation!

5. Report interim results

Effective budgeting requires clear communication across the whole organization, not only upon preparation but also during the implementation phase. To that end, reporting actual interim results versus budgeted figures is the next key step to consider. Financial analysts should monitor major variances and explain the reasons for them. This feedback can also be used as a basis for preparing next year's annual business plan.

With time, the company can **adjust and revise** goals and expectations and start all over again in the following financial period. It's a never-ending process that goes along with the firm's operations.

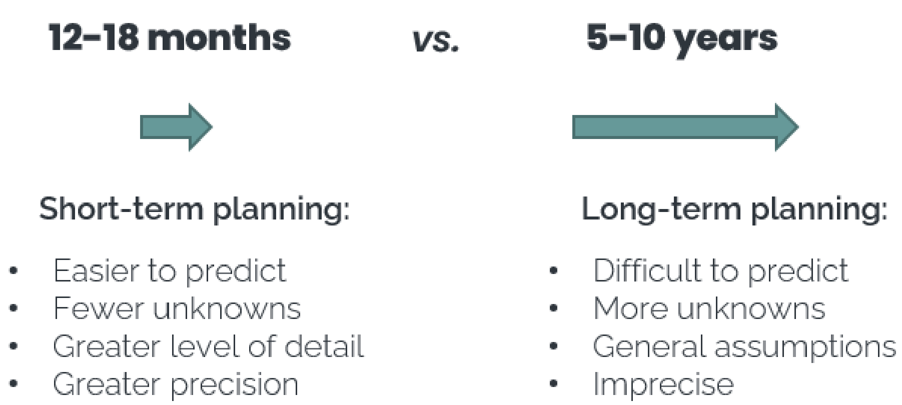
3.3. The Budget Horizon

In terms of time horizon, there are two types of budgets:

- **Short-term budgets** – for the next 12 to 18 months
- **Long-term budgets** – for the next 5 to 10 years

It is easier to forecast short-term events because there are fewer unknown variables to be planned for. Hence, short-term planning can be done with greater precision, as drivers will be less likely to change drastically over the next 12 months. Besides, there is plenty of information at hand to support a solid short-term budget.

Long-term planning, on the other hand, is associated with many unknown variables, general assumptions, and a lower level of precision.



3.4. The Budgeted Levels of Detail

There are three main ways to look at a business from a planning perspective:

- At a **general level** – make projections as to whether a business is profitable by considering its core strategy and positioning. In other words, we take a more strategic look at an organization – the markets it plans to enter, the customers it needs to target, or even the internal skills and capabilities it must acquire. This is also known as top-level budgeting.

- At a **tactical level** - specify how a company intends to achieve its core strategy. Tactical budgeting involves making a breakdown of **relevant objectives** and coming up with long-term targets. This provides a more detailed prediction of what will happen in the future.

- At **an operational level** – prepare a very detailed plan for the upcoming months or years, aiming to support operations and focusing on specific financial targets. Operational budgets are complex models as they require a great number of input variables and details to be considered.

The Budget represents a plan for the future, formalized in quantitative terms. Think of it as an actionable blueprint of a company's objectives.

3.5. Budgeting Approaches

Bottom-up approach – Progresses upwards from the lowest level; you need operational indicators as inputs. It is much more detailed and consists of providing detailed projections.

For example, when budgeting the revenue of a hotel, you can use the following formula:

Expected revenue = Number of rooms x Occupancy rate x Price per room

Top-down approach – Considers macro-indicators at the top level; it leverages general industry and macroeconomic assumptions.

For example, when budgeting the revenue of a hotel, you can use the following formula:

Expected revenue = Value of the total hotel industry x Expected Market share of the hotel

Please Note!

Short-term planning often uses both approaches and compares them in order to triangulate the results. Ideally, the bottom-up and the top-down method should agree on projections.

When it comes to **long-term budgeting**, though, firms mostly avoid implementing the bottom-up approach, as there are far too many unknown variables to be projected. The unavailability of detailed information makes the bottom-up approach useless for straegic planning.

3.6. Updating the Budget

Business planning is important because it allows executives to specify and track the achievement of financial goals and objectives. In that way, they can gauge whether the actual performance of the company corresponds to the projected one.

Budgeting is a tool that provides a significant level of accountability and can be used as a reality check.

Most companies employ flexible planning techniques on top of the static budget, allowing them to review their results on a monthly, quarterly, or half-year basis. They often submit monthly forecasts that correspond better to the current business environment and are updated with the latest estimates for the period.

In extreme cases, companies might revise the budget for the year, i.e. when the initial budget proves useless because a significant and unforeseen event has arisen after its final sign-off. For example, many corporations had to prepare After-COVID 19 budgets and re-submit them for approval. This allowed companies to adjust their forecasts due to newly emerged circumstances, as well as to plan how to deal with them going forward. At the end of the day, any budget needs to reflect reality as closely as possible!

3.7. Who Prepares the Budget?

Budgeting is a complex process. It is a joint effort that requires various stakeholders to present their views on the future. The most realistic budgets are prepared by companies that involve their employees in the decision-making process. Employees from various departments must be consulted:

- Sales Teams
- Supply Chain Team
- Marketing Team
- HR Team
- Finance Team

Department managers are the ones responsible for consolidating the information from their teams. Once this is complete, they submit it to the **Budget Committee**. It puts all the data together and works toward creating a complete Budget for the entire firm. Usually, employees from the Finance Department, department managers, and the chief executives of an organization are among members of the Budget Committee.

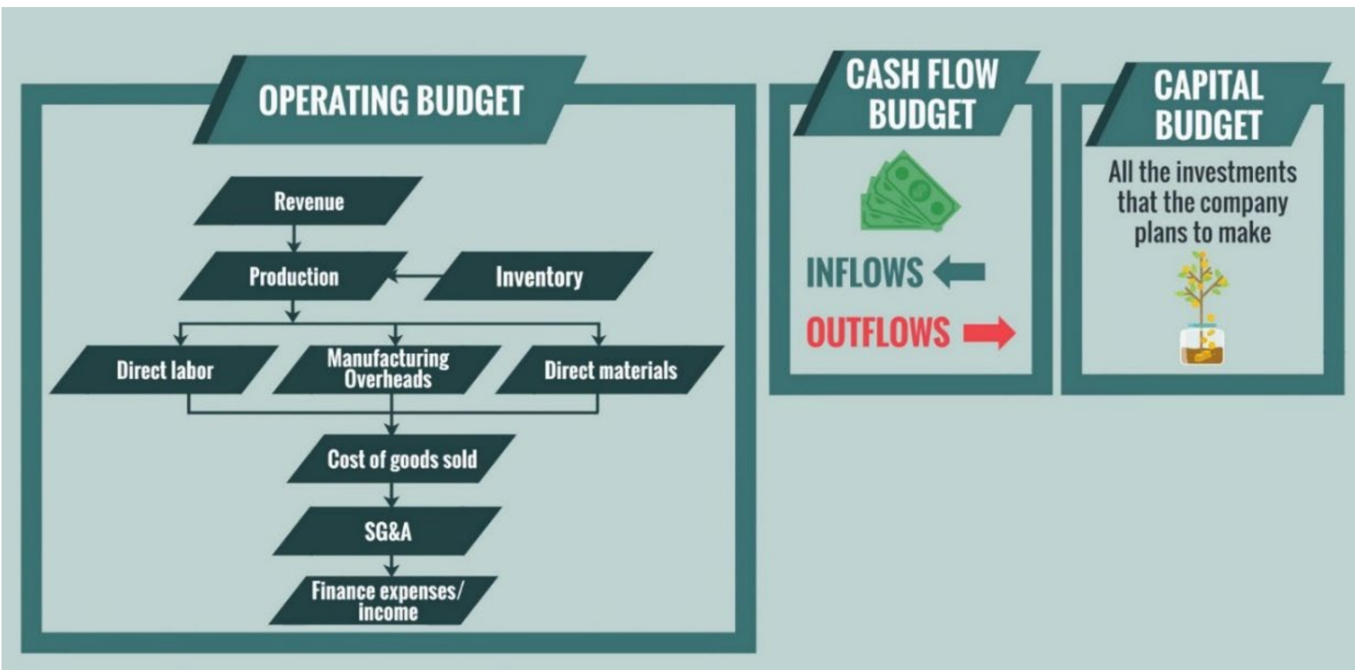
Every organization prepares separate functional budgets – sales, production, marketing, payroll, and others – before compiling them in a single comprehensive model. Once Division Heads send all of the information over to the Budget Committee, they can start putting the pieces together to create the Master Budget.

3.8. The Master Budget

The **Master Budget** is a document that aggregates all of the inputs submitted by the various departments when preparing an annual business plan – a combination of the inputs from the firm's different business units, departments, and cost centers.

The Master Budget has three main components:

- **The Operating Budget** – includes all the items that affect Net Income (Revenue, COGS, Production, and various expense budgets)
- **The Cash Flow Budget** – includes all expected cash inflows and outflows
- **The Capital Budget** – shows the total amount of expected capital investments (fixed assets)



3.9. Budget Approval - the Final Sign-Off

The **Budgeting Committee** plays the role of intermediator between the owners of the company and its management.

Shareholders and Board Members are usually more ambitious and less cautious with their predictions. By contrast, mid-management and finance executives prefer to target results that are easier to achieve; they wouldn't want to be held accountable for not meeting targets.

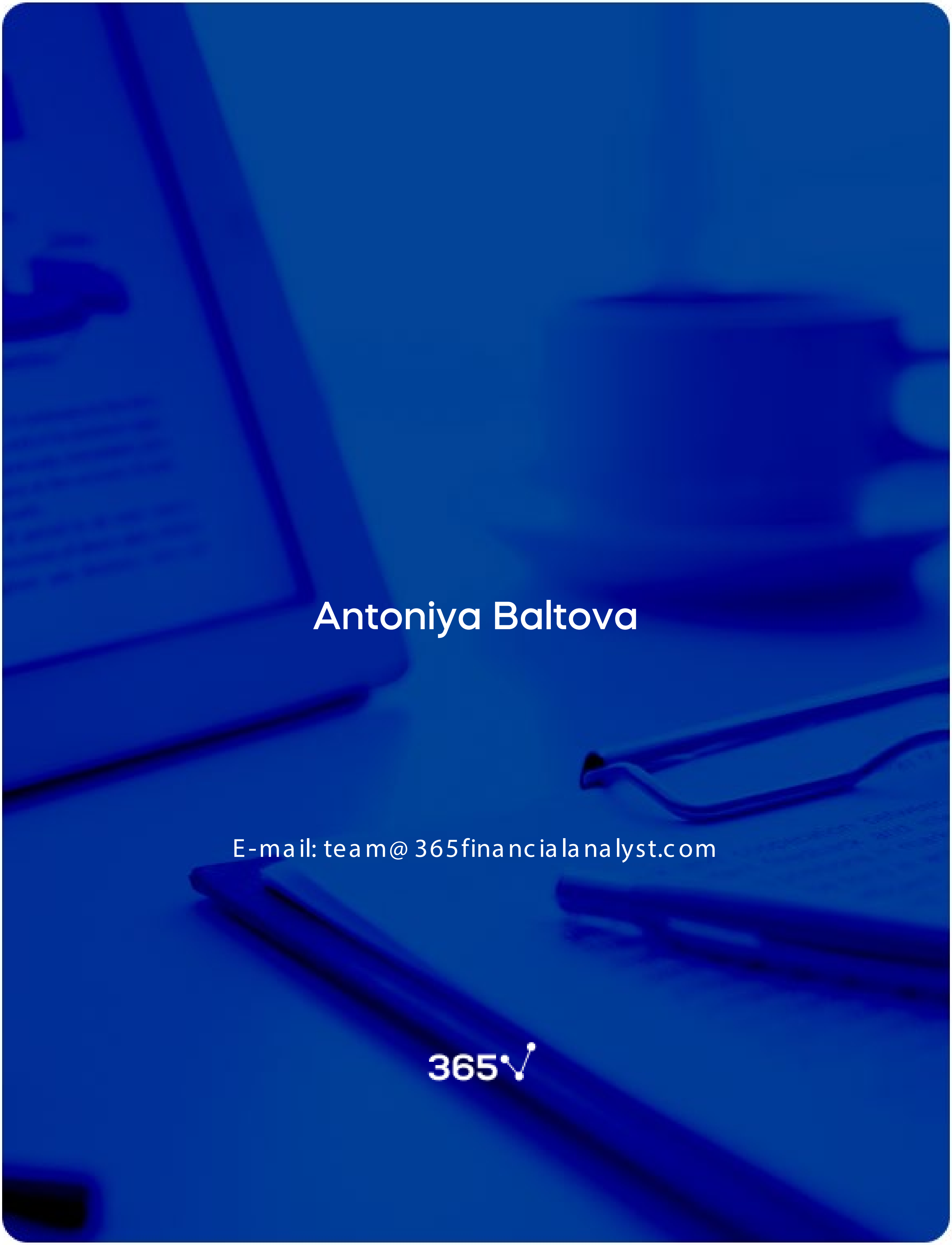
In search of the golden mean, the preliminary projections are triangulated between the expectations of shareholders and top management. Usually, the owners of a company tend to make a top-down estimate, while each division creates the budget from the bottom up. The two sides reach a compromise during the budget discussions.

Proper communication is the key to an efficient budgeting process.

Members of the Budget Committee are skilled enough to properly relay the information between all the stakeholders involved in the budget preparation process. Once an agreement is reached, the budget is ready for final approval and sign-off.

Section 4: Henry's Hats Case Study

Please refer to Henry's Hats Complete Solution Excel file attached to the course.



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