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ELABORATION OF KEY ASPECTS OF FINANCIAL PLANNING IN ENTREPRENEURIAL ENDEAVOURS

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Abstract. *The main objective of this paper is to analyze the special role and instruments of financial planning for small enterprises and entrepreneurs. The author of the paper advocates the use of modern tools of financial planning such as break even, cash flow analysis, liquidity and monitoring point to achieve better performance in the operation of modern businesses.*

Key Words: *financial planning, break even point, cash flow, liquidity monitoring*

1. INTRODUCTION

It is highly improbable that we could invent something that would be useful for the general entrepreneurial culture [21, p.2] without reiterating providing undisputed proof that every entrepreneurial endeavor requires at least five crucial interconnected phases of the management process. That is exactly why this paper begins with the logical flow of entrepreneurial endeavors. This will be followed by elaboration as to how financial planning [2, p.132-161] in particular influences further development of a business idea.

Skilful financial management is one of the best ways to fructify one's own personal capital, which is scarce, and to ensure that the business stays profitable, liquid and solvent. Solvency is a global capacity of a business to sustain a business risk and to secure the return of borrowed assets on a long-term basis [10, p.10]. It is measured by capital adequacy. Liquidity is the readiness of a business to settle its liabilities as they mature while maintaining the normal flow of business activities. Thus, liquidity should be constantly analyzed from the standpoint of required amount of financial assets and as a function of time. Contrary to this, illiquidity is a situation when a business is unable to settle its liabilities. Causes of illiquidity may relate to one of the following: quantitative balance sheet inconsistency, particularly of the between receivables and liabilities[8, p.68-71], inflow and outflow, i.e. the situation when liabilities exceed receivables. It is precisely the liquidity indicators [9, p.52-53] that

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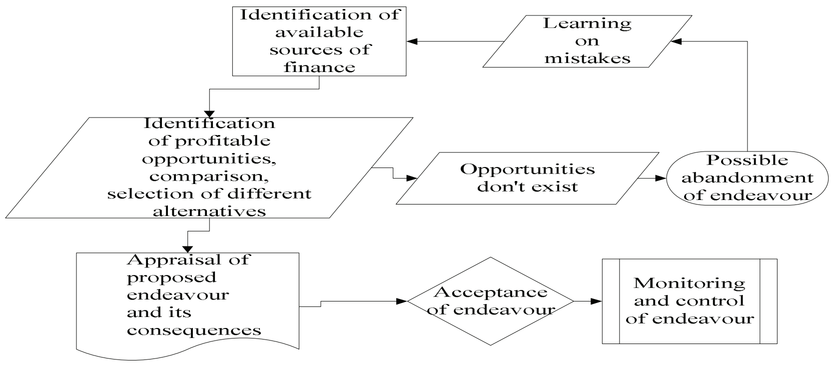
demonstrate whether a business has the capacity to settle its liabilities. For this purpose we use the so-called financial ratio [19, p.510] analysis [4, p.86]. The manner in which business finance is managed represents a key question for every successful entrepreneurial endeavor. It is therefore very important that receivables are actually collectible. In this sense, every year thousands of potentially successful endeavors fail due to financial mismanagement. After defining the basic fundamentals of planning the sequence and flow of entrepreneurial endeavors, we will now offer for discussion our detailed elaboration of the role and significance of financial planning in this field.



Organizational diagram 1. Flow of an entrepreneurial endeavor

2. THE SPECIAL ROLE OF FINANCIAL PLANNING IN ENTREPRENEURIAL ENDEAVORS

Together with controlling, organizing and analyzing, financial planning is the key function of financial management. First, it includes development of financial plans which will serve as a starting point for financial decision making. Second, it transforms long-term goals [16, p.119] which are formulated in the business plan into numbers and predicts revenues, expenditures and profit. Third, it also deals with future value and liquidity of a business. Furthermore, financial planning compels the management to actively deal with the future of a business. Other distinct advantages of financial planning include:

- Planned tasks can be continuously compared to business reality only if there is a previously compiled financial plan.
- Problems can be promptly recognized and adequate countermeasures taken;
- During each planning period opportunities are extended to check the current business situation in terms of self control.

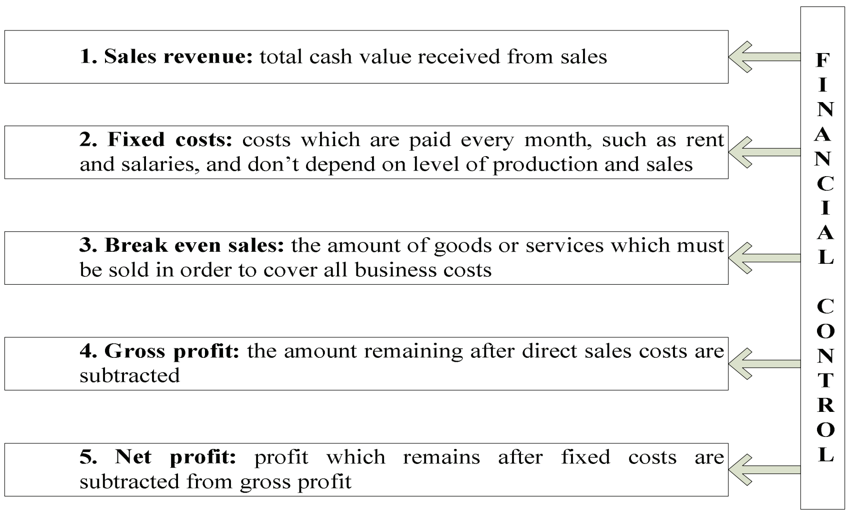
In our opinion, shared by Kenich Omae, this aspect should be differentiated in relation to the significance of production planning, personnel planning (corporation) and marketing planning (in relation to competition), since these are also important functions of business planning [14, p.100].

2.1. Central instruments of financial planning

Proceeding from ex-post financial reports (balance sheet and profit and loss statement) and regardless of whether it concerns a large, medium or small enterprise, sound financial planning includes at least the following three instruments:

1. Cash inflow plan (Also called a budget and its main role is to show expected profit in the following year)
2. Planned balance sheet (Balance sheet forecasts the value of assets and source of finance)
3. Liquidity plan, which predicts current payments in one year with a review of the situation by months

There exists interconnectedness between these central instruments of financial planning. For example, 'profit' estimated cash inflow plan influences both debtors in the balance sheet and maturity of payments in the liquidity plan [24, p.104-117]. If a business carries out financial planning, then the following year is planned in detail while a rough outlook for the next two or three years is provided. Concerning this approach the rule of thumb states that: a business should plan as realistically as it is possible and as detailed as it is necessary. Financial planning can also be done for individual parts of a business and products, and not just for the whole organizations. A bank that finances a business often considers it good business policy if the financial planning is performed. For instance, the numbers obtained by planning show whether there is an additional necessity for capital due to planned investments and when a difficult situation concerning liquidity could arise. In that scenario the bank and an entrepreneur can jointly develop in forward looking suitable financial solutions, addressing both aspects of time and structure of capital. At the same time, the bank gets an overall picture of the cash flow in a business, which facilitates loan approval and improves the credit rating of its client. Banks particularly tend to assess the following leading criteria of credit rating: previous credit history, accounting and financial systems, financial situation, legal status, market position, availability of mortgage and guarantees, entrepreneurial reputation, technical and business abilities, project and investments sustainability, repayment capacity, readiness to accept an interest rate. Available capital for a business (both internal and external) should be invested wisely and managed successfully so that all financial obligations can be settled on time. It requires a suitable and realistic *financial plan (*the most important and the most complex parts of a business plan) which consists of the following elements:



Organizational diagram 2 Elements of a financial plan

In the previous organizational diagram we can see individual elements of a financial plan and the key role of financial control. The research conducted by Harvard professor ***McClelland in*** 1960 showed that entrepreneurs who had clearly defined goals and developed plans were more successful than others. Therefore, the tables in which a business is planned should include special columns in for each of the following: planned numbers, real numbers, variances, textual comments and measures.

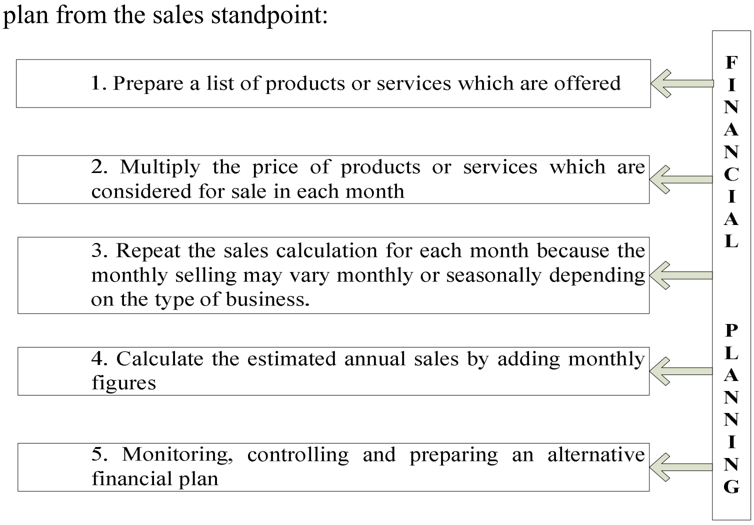
Variances should also be expressed in terms of percentages although they attract attention in the form of absolute numbers. Textual comments should consist of short, clear sentences that can indicate the cause of variances. It should be emphasized that the plan of cash inflow should have the same form as in the accounting of a business. This makes the comparison between real and planned values easier to make. Financial manager does not control only figures. It is equally important to recognize causes and to realize the relationship between financial phenomena. The liquidity plan is also controlled on a monthly basis, depending on the situation in the company. It is also recommendable to compare payments weekly. The cash flow plan and balance sheet is controlled quarterly or biannually, while turnover is controlled on a monthly basis.

3. Forms of financial planning

Analyzing Anglo-Saxon literature, professor Milisavljević M. gives an example of General Motors where planning is conducted in three specific forms: pessimistic (with the least expected return rate) [3, p.243-247], conservative (according to normal conditions of business operations) and optimistic (it implies significant growth of sales and return on investments) [1, p.87]. In market based economies this seems to be the most appropriate approach.

3.1. Planning sales and costs

The following organizational diagram will briefly illustrate the process of preparing a financial plan from the sales standpoint:



Organizational diagram 3 The process of preparing a financial plan

The first task in the process of developing a financial plan (it is about a process, and not a once occurring act) is to evaluate the total sales in the first business year. Forecasting sales will probably be difficult for the start-up enterprises and those entrepreneurs without historical data for forecasting. But that is a necessary part of a financial plan. In order to ensure business survival forecasts should be realistic and not based on desired sales. The most reliable forecasts are based on operations of the competition, market research and clients' needs. The process of developing the first financial plan is presented in the previous diagram. The second step in finalizing the financial plan refers to defining the initial including all individual costs of entrepreneurs or the SME [13, p.17-37] while governments try to stimulate the process by reducing [15, p.83] these costs [20, p.58]. One should be realistic when costs are concerned. It is not recommendable to apply for a loan and then subsequently find out that it is not sufficient to cover business and investment costs. That's the best way an entrepreneur loses credibility as a client of banks. *The initial budget normally takes into consideration the following types of costs:*

- Costs of employees, legal and administrative costs
- Rental costs including renovation and re-designing it,
- Licenses/approvals, insurance,
- Equipment and stock,
- Advertising, promotion, travel,
- Electricity, water,
- Personal costs and debts,
- Supplies.

The size of a given business will partially influence the individual costs and their value. One more cost, often neglected when a business starts up is the opportunity cost. This is the value of something abandoned or is not undertaken for the sake of a new business endeavor. For example, an entrepreneur needs a year to start a new business. A question is raised what other activities he could start in that year. Is the gain greater on the planned or the missed business? If a new business costs a certain amount, is it worthwhile spending the whole saving for that endeavor or is the gain greater on some other business? Those are only a few questions requiring answers. Stubborn insistency on the bad idea can be very expensive in the sense of time lost and missed business opportunities.

Once the basic financial tools are understood, it is possible to start building a detailed financial plan. That requires appropriate answers on the following central questions:

- How much does it cost to start a new business/ expand the existing?
- What are the estimated annual sales?
- What are the estimated annual costs?
- What are the expected annual profits?

Certain things are totally identical regardless of whether an entrepreneur deals with production or services. Firstly, one needs to spend the resources in order to gain the profit after completing the product- service cycle. Therefore certain material preconditions must be fulfilled in order for the business plan to be realized.

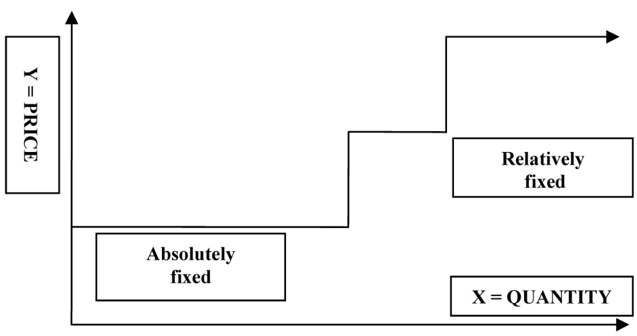
Once the business starts short-term and mature liabilities are the crucial questions for the small and medium enterprises. Their market position is totally different from large enterprises that are frequently able to provide better discounts and deferred payments than small enterprises. Thus it is more complicated to manage the short-term liabilities within the small enterprises, especially if at the same time management of receivables is not efficiently organized. Both sub-functions of financial management need high level of expertise and introduction of information systems within the working process.

3.2. Planning and managing costs and tax liabilities

No matter how a business expands, managers have to take care of costs in order to successfully plan production, prices, manage tax liabilities and avoid being caught in cycles of illiquidity and this requires careful cost management [23, p.196,348]. Cost management has to include the following key elements:

- Investments into facilities, construction work
- Investments into procurement and installment of basic equipment
- Investments into additional equipment
- Depreciation and maintenance costs
- Insurance premium costs
- Interest costs for the repayment credit funds.

In formal classification theory, there is a basic division of costs on fixed, semi-variable and variable. The following diagram depicts the movement of fixed costs.



Organizational diagram 4 Absolute and relatively fixed costs versus business expansion

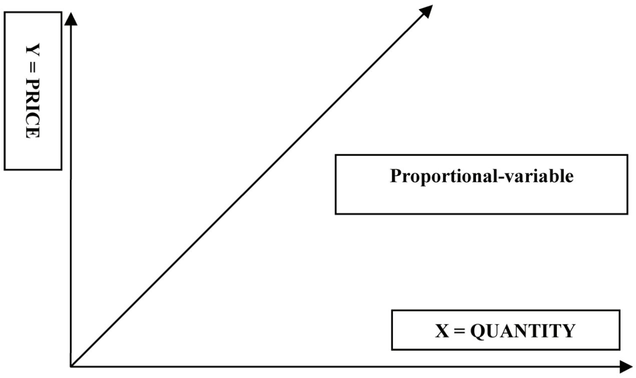
Typical fixed costs in a small enterprise include hiring, insurance, maintenance, and salaries. When discussing fixed costs then we mean that they don't react to the level and volume of business activity or capacity utilization.

Fixed costs [21 p.55, 84, 118] exist even if a business from some reason does not operate: when they are absolutely fixed, they always stay equal (stable) no matter what change in capacity level takes place, and one should differentiate them from relatively fixed costs.

Contrary to fixed costs, variable costs vary depending on the volume of economic activities and capacity utilization that is directly reflected on costs of energy, workforce, materials and raw materials.

Semi-variable costs include, for example, the costs of electricity and telephone.

As can be seen from the following diagram variable costs react to the changes in the level of the capacity utilization, so they rise (fall) equally as the capacity utilization rises (falls).



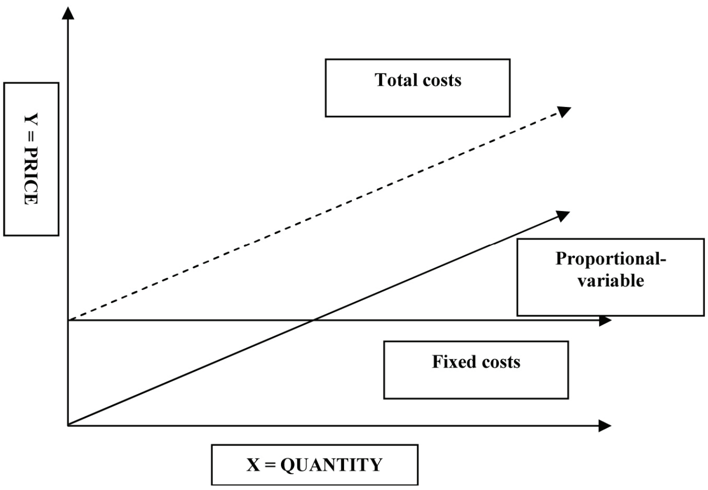
Organizational diagram 5 Proportional - variable costs vis-à-vis capacity utilization

Logically, the total costs [17, p.84-89] are then received when the fixed and variable costs are added up.

Formula 1 Total, fixed, variable costs

$$TC = FC + VC$$
$$FC = TC - VC$$
$$VC = TC - FC$$

The following diagram depicts fixed, variable and total costs.



Organizational diagram 6 The basic classification of costs

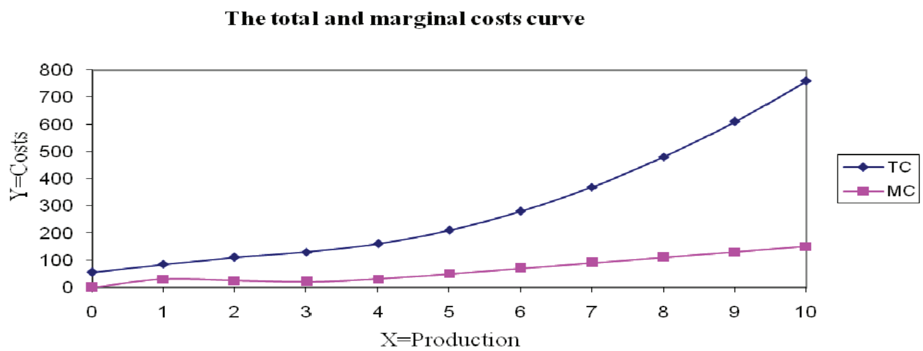
The division of costs into fixed and variable is relevant only for a short period of business operation, because all costs for on the long run tend to become variable. On the short run the so-called marginal costs are much more important t for the cash flow of a business.

Marginal costs indicate the marginal rise of total costs, conditioned by the production of an additional unit of production. Let's examine the following hypothetic example with the movement of total and marginal costs during a ten-year production. This will be followed by a curve of total and marginal costs.

Table 1 The progression and movement of total and marginal costs

X=Production	Y=TC	ΔY/ΔX=MC
0	55	0
1	85	30
2	110	25
3	130	20
4	160	30
5	210	50
6	280	70
7	370	90
8	480	110
9	610	130
10	760	150

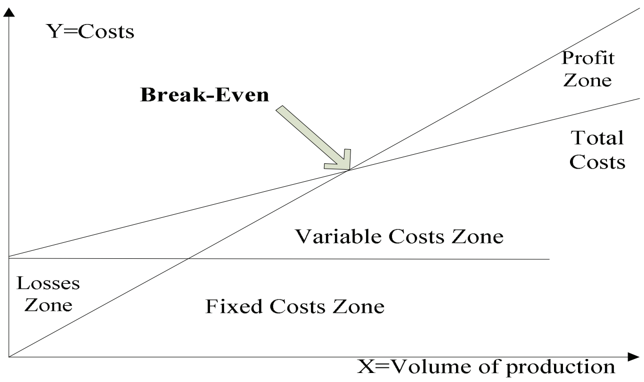
We can see the constant rise of total costs, the initial fluctuation of marginal costs, and then the rise of marginal costs although much more modest. Let us examine the following graphic scheme by using the same empirical (hypothetic) data [26, p.175].



Organizational diagram 7 The total and marginal costs curve

We can see that after the mild fall of marginal costs in the second and third year there is progression of marginal the speed of which is of course far slower than with the total costs. In order to mathematically determine the moment and volume of production when a business covers all its costs and begins making profit, we use the breakpoint technique [7, p.296-298].

Examine at the position and importance of break-even point [10, p.331-333] in financial analysis[19, p.30-50] from the following diagram:



Organization diagram 8 Break-Even point

The break-even point is crucial for financial analysis, because this is where the total income equals the total costs. Recognizing this point, financial management of a business can effectively manage costs and successfully determine the optimum size of a firm. This is significant for the phase when the micro or small enterprise enters the growth phase, generates growing incomes and decides whether or not it is going to become middle size enterprise or not. The same goes with middle-sized enterprises that face a dilemma whether to become a large enterprise or not. The analysis of break-even point is also useful for large enterprises in the phase of recovery, privatization, or downsizing when some parts of the enterprise become profitable entities. On this occasion we will examine two formulae, calculation of sales at break-even and presentation of break-even in percentages. The appropriate formulae for break-even analysis are as follows:

Formula 2 Calculation of sales at break-even point

$$\text{Sales at break - even} = \frac{\text{Fixed costs}}{\text{Sales price - direct costs per unit}}$$

Formula 3 Presentation of break-even in percentage

$$BE = \frac{FC}{TR - VC}100$$

When considering effective management of SME costs, it should be pointed out that advantages and benefits from innovation, creativity and establishing new processes reduces [6, p.324] costs [5, p.192-206]. Re-engineering of inventory processes for example can also reduce the operating costs of a business and expand the zone of profits as discussed in our diagram. Some of authors specifically differentiate between reducing the *alpha-phase* costs (costs from a new process) and *beta-phase*-costs (costs as a result of the later improvements of new processes). It has been established in research that the reducing of costs in *beta phase is* far greater (4,5% compared to 1,5% in alpha phase). On this basis one may conclude that the improvement of processes has contributed far more to technologic progress than the initial invention. In a similar attempt, the Japanese approach of reducing the costs is based on the so-called Kaizen *Costing* [12, p.221] and is related to the whole life cycle of business costs. This cost management technique is tightly connected development functions and approaches of a business. It is focused on reducing of costs within the individual phases of production. Since the costs savings with can achieved in earlier phases of the targeted planning and spending of materials and resources (target costing) the savings in individual phases of production tend to be smaller. The original Japanese word for Kaizen in fact implies little savings per phase. Kaizen approach assumes an effort to reduce the costs of production in the current phase in comparison to the previous. In this concept production workers are encouraged to make individual savings based on the basis of acquired experience and knowledge. Savings in costs, achieved in this way, can be significant. Tax liabilities and government budget deficit management also represent an important element of operative and strategic financial management [25, p.199]. Tax rates on added value and income taxes are defined by law. Entrepreneurs have to manage this aspect of their business when dealing with their financial plans, liabilities and costs. The question of taxes is equally important when considering investment decisions. Profits made from investments are also going to be taxed (The tax on profit in Serbia at the moment of writing this paper is 10 %), while some capital investments can get receive tax benefits. Operating a business in special zones, business incubators, technological parks and business centers can also bring important tax benefits to entrepreneurs. We will dwell into these aspects of financial management in our next article.

4. Conclusion

Scientific research on financial planning for SME growth represents, at least in our opinion, a key area of interest for financial management as applied discipline of management. Together with other relevant disciplines management should concentrate on those variables which can potentially describe in more detail the management of costs and application of modern methods of analysis such as break-even which would increase the capacities of entrepreneurs and SMEs. In a similar way, it is definitely possible to use other criteria as well.

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NEKI KLJUČNI ASPEKTI FINANSIJSKOG PLANIRANJA U PREDUZETNIČKIM PODUHVATIMA

Milan B. Vemić

Ovaj rad pokazuje da je finansijsko planiranje ključna funkcija finansijskog menadžmenta malih preduzeća i preduzetnika. Autor obrađuje instrumente, forme i ročnost finansijskog planiranja kao centralne aspekte ukupnih, fiksnih i varijabilnih troškova koji se stavljaju u kontekstu prelomne tačke rentabilnosti i savremene racio analize.

Ključne reči: *finansijsko planiranje, prelomna tačka rentabilnosti, analiza tokova gotovine analiza, praćenje likvidnosti.*