Integrating the strategic planning process with budgeting

In this day and age of globalisation and technological advancements where companies anywhere in the world operate in one global economy rather than in a regional economy in isolation from the rest of the world, economic entities must think strategically both on a short-term as well as on a long-term basis. They must be able to identify opportunities and to assess their own internal strengths and weaknesses in order to respond in a timely manner to these opportunities in a dynamic environment. Strategic planning done annually will force members of an organisation to think about what needs to be done in line with opportunities and threats faced externally, and will facilitate goal congruence among various sub-units of the organisation which are working towards common corporate objectives.

The strategic planning process

The process begins with the identification of mission statements. These are broad statements reflecting the core aims of the organisation. They do not indicate the paths or mechanisms used in achieving these aims. An example would be 'to be one of the leading companies in the automotive parts-manufacturing industry'. Generally speaking, organisations confine the number of mission statements to no more than six or so. The identification of these mission statements is usually the responsibility of the Executive Committee with subsequent ratification by the Board of Directors.

Next comes the development of corporate objectives in line with the mission statements. These corporate objectives specify ways and means by which missions can be accomplished. In line with the aforementioned mission statement of 'being one of the leading companies in the automotive parts-manufacturing industry', one might come up with corporate objectives such as:

- To increase market share of the company's sales to 35 per cent of the industry's total sales;
- To provide quality products to the automotive manufacturing industry;
- To provide quality service and timely delivery to its customers.

Depending on the number of mission statements identified, the number of corporate objectives could be either lengthy or short. In order to help departments cope with the implementation of strategies, the number of corporate objectives must be manageable within the planning horizon and are usually around ten or so. The Executive Committee (president, vice-presidents and department directors) normally would develop the corporate objectives.

Next comes the development of departmental action-oriented goals. Each department in the organisation will take each corporate objective as a response area, and see if initiatives can be arrived at to contribute to the successful accomplishment of that corporate objective.

Where departments are unable to contribute to a certain corporate objective, they will skip that objective and proceed to the next one. For example, as a departmental action-oriented goal, the Personnel Department in response to the corporate objective of 'providing quality products to the automotive manufacturing industry', will initiate a goal of 'recruiting the best qualified design engineers'. The Corporate Training Department might list as one of its goals 'the development of a training programme to enhance the effectiveness and efficiency of the company's sales force' in order to increase the market share of company's sales to 35 per cent of the industry's total sales. The Finance Department might list as one of its goals, 'the development of performance measurement yardsticks to measure the success or failure of all of the three aforementioned corporate objectives'. The Security Department may not be able to contribute directly to any of these three objectives and may have to move on to the next set of objectives.

Critical success factors vs inhibitors

As action-oriented goals are being developed by the departments, they must come up with a list of critical success factors and a list of inhibitors. Critical success factors are those aspects of the goal that must occur before a department can say it has achieved what it has set out to accomplish. For example, in order to submit the Board Report by Friday noon, the Finance Department must have received the computer printout with the raw data by Wednesday afternoon at the latest. Inhibitors are situations that prevent the smooth accomplishment of certain goals. Contingency plans must be developed to work around these situations should they occur. An example would be that backup programmes might be developed to cope with occasional system breakdowns. When developing the departmental goals, care must be taken to ensure that these goals are initiated in light of the organisation's own internal strengths and weaknesses and resource constraints.

Last but not least is the development of performance measures in monitoring the initiatives taken by the departments. These measures could vary quite extensively depending on the type of goals set. They could range from quantitative to qualitative ones. Some companies have the Corporate Planning and Budgeting functions grouped under one department and the Director of that department will work with the various line and staff department directors in coming up with performance measures either company-wide or custom-tailored for each individual department.

The annual budgeting exercise

Accountants in general are familiar with the annual exercises of budget planning, budget development and subsequent budget control. Therefore, detailed descriptions of the various phases of budgeting will not be given here. However, worthy of note are two aspects: sequence of budgeting and the approach to capital budgeting.

It is recommended that the capital budget of the organisation be prepared prior to the preparation of the operating budget. Experience will tell us that the acquisition of capital assets will lead to the incurrence of additional operating expenditures, e.g. manpower costs, depreciation, repairs and maintenance, etc. To do it in reverse order will invariably underestimate operating expenses or lead to the ensuing revision of the operating budget.

A large percentage of companies worldwide do not employ systematic methods in planning for capital asset acquisitions. Many still make capital decisions on the spur of the moment or resort to primitive methods that do not take the time value of money into consideration or do not facilitate the accurate ranking of projects at times of capital rationing. Methods involving discounted cash flows (DCFs) should be used to overcome the aforementioned situations and to allocate limited resources in a most appropriate manner in accordance with the objective of profit optimisation. Such methods would be applied to projects involving cost reduction, revenue generation or efficiency improvement, etc and not to projects that are merely machinery replacements, capacity expansion or a result of governmental regulation, etc.

Companies that do adopt discounted cash flow techniques often use the internal rate of return (IRR) method, simply because it provides a rate of return that most people, including non-accountants, can relate to. The superior method of net present value (NPV) is often ignored as it only provides a positive or negative residual dollar amount in present value terms. This may be difficult for non-accountants to relate to and does not facilitate ranking of projects with different magnitudes of investment outlay.

Problems with IRR

The IRR has a serious flaw as its annual cash flow amounts (whether positive or negative) are presumed to be reinvested at the internal project rate, thus generating a compounding effect. For example, if the initial present value returns are at 17 per cent, it is assumed under IRR that annual cash flow amounts from the project are re-invested each year at 17 per cent for the life of the project when these cash flows may not be re-invested at all. In order to overcome this flaw and to provide a percentage return measurement, the British Columbia Forest Products Ltd (now Norske Skog Canada Ltd), a subsidiary of the Mead Corporation in the United States, used, in the early seventies, a discounted corporate cash flow technique. This approach compounds all cash inflows to the end of the final year of the project and discounts all cash outflows to year zero using the weighted average cost of capital. Discounted cash inflows are then divided by discounted cash outflows to come up with a discounted percentage return.

As capital assets are long-lived assets with substantial financial ramifications should the wrong decision be made, careful planning and rationing among competing departments are warranted. Post appraisals or post-implementation audits of capital expenditures against the plan become a must. The results of such reviews should not be used to discredit the project originator if the returns fall short of what was planned. Instead, they should be used as a lesson to learn in the event that similar projects are initiated in the future.

The need for integration

Except for major corporations, most companies do not have a formal strategic planning function. Those that do have the function may have it separate from budgeting and have the activities planned and coordinated by wiz-kids who do not necessarily have a financial background. Hence the timing for strategic planning may not coincide with the budget season, let alone allow the two functions to integrate. Costs for the implementation of departmental action-oriented goals may or may not be reflected in the capital and operating budgets. The flip side of the coin is that departmental goals and contingency plans may be ambitious and without due consideration to budget constraints.

The annual strategic plan sets out the corporate objectives (in line with the organisation's core aims), which in turn form the blueprint for departments to develop their action-plans for the year. Unless budgets are developed from zero-base each year, implementation costs for departmental goals are incremental (over and above the day-to-day routine activities that are non goal-related) and must be reflected in the budget packages.

A large number of major corporations that practice strategic planning still keep the function separate from budgeting. While it is perfectly acceptable for the two functions to be carried out under two separate roofs, integration does require that the two groups work cohesively in a team, both functionally and in spirit.

There are at least two tasks, the achievement of which would assist integration immensely. Firstly, the timing of the annual budgeting exercise should be scheduled to coincide with that of strategic planning. As departments plan for their action-oriented goals and prepare their budgets at the same time, costs associated with and are only specific to these planned action-goals will not be overlooked during the budgeting exercise.

Secondly, it is highly advisable that training sessions on cost behaviour and budget preparation be given to all departments by the Finance Department. With a decent understanding of cost behaviour, departments are in a better position to identify incremental costs that are solely goal-related. Mission statements and corporate objectives are developed globally and they do not affect the budget. Only action-oriented goals developed at the departmental level have budget implications. As such, each goal and each contingency plan, if any, must be carefully reviewed to determine whether additional capital and operational outlay are required.

It would certainly help if the strategic planning and budgeting functions were to be grouped under one department either within the overall finance area or outside finance, reporting directly to the CEO. Those departmental staff not involved in financial analysis and evaluation (primarily relating to capital budgeting) need not be accountants by profession. What they do need are the generic skills of thinking strategically and creatively, and of communicating planning policies and procedures, and coordinating and consolidating input from various organisational sub-units.

THEODORE TY CHEN IS CURRENTLY PROFESSOR AND HEAD OF DEPARTMENT OF ACCOUNTING AT HONG KONG SHUE YAN COLLEGE.