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Conceptual and practical aspects of financial planning and control

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CONCEPTUAL AND PRACTICAL ASPECTS OF FINANCIAL PLANNING AND CONTROL

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INTRODUCTION

Someone once said jokingly, ". . . .That works fine in practice, but will it work in theory?" In reflecting on this statement, it occurs to me that perhaps this is sometimes not a funny thing at all–but rather a reflection of a failing that many times exists in the administration of the management process in many corporate hierarchies today.

By this I mean that, all too often, we tend to get so entranced by the mechanics of "doing things" that we completely lose sight of not only the "real goal", but also the basic conceptual framework that should always precede the "actual doing."

What I would like to provide today is not a discourse on all aspects of the complex theory of corporate management science, but rather a brief discussion of how abuse of this concept can occur in the process of developing an effective and viable system of financial planning and control, and of what can be done to avoid it.

THE MANAGEMENT SYNTHESIS

Let's first define what it is we are attempting to achieve by the management process.

As a business grows ever larger and more complex in today's competitive world, management's need to assign responsibility for results becomes ever more urgent, for the work of the many individual managers of a company adds up to the total profitability of the enterprise. Managers must be motivated; their work must be coordinated and controlled; and the results must be evaluated in the light of the goals of the business.

Now, since management is simply the art of getting things done through people, things can't really get done unless people know what the goals are–what is to be accomplished, why it should be accomplished, how they will benefit from it, and what role they will play in accomplishing it. A board of directors, a president, or a top management committee cannot achieve goals unaided. The entire management team must be aboard, or the enterprise will never get where it wants to go.

Therefore, we can see that the management process is the day-to-day decision-making and control exercised by a group of people all working toward common goals. Establishing objectives and standards of performance are techniques for insuring effective integration of this group of people for direction and control, and their planned use thus becomes the heart of the management process.

Since a basic condition in continuing to work toward these goals is the need to provide the money to pay for the men, the materials, and the machinery required to accomplish the goals, it then becomes rather important that the outflow of money not exceed the inflow of money from the business enterprise. Hence, company managements have said, "wouldn't it be a great idea to develop a financial planning and control system so that we can plan and monitor the hoped for profitability of the company?"

Now this is a good idea, but all too often what then happens is that everyone scurries around developing some budgets, making some forecasts, and designing some forms so that they can now look at actual numbers next to the planned numbers. But wait a minute. Aren't we building the engine before we design the car that is going to take us down the road to our ultimate destination? Aren't we putting the cart before the horse in the sense that we should first know where we want to be before we set out to get there? I submit that, with no better concepts than these, we are doing just that.

There are "more basic" things we should do first.

THE FRAMEWORK

The first thing that must be done is to design a basic framework within which all of this can operate. And the first thing we come to in so doing is a very important definitional problem that must be answered. That is to define the business purpose. What kind of business do we want to be in now and many years from now? This business definition should be the very first act of the objective-setting effort. In a sense, such a formal definition of the corporate profile tells the objective of the whole enterprise. Answers should be developed for questions such as:

- What products and services do we want to offer?
- What is the marketplace?
  - What is our window in that marketplace?
- How are we going to get our product or service to the buyer?
- How are we going to make the products?
  - What facilities are needed to do so?
- Who are the people we need to do all of these things?
- And finally, how are we going to fund it all?

A vice-president of a large industrial concern summed it up very well by calling this a "vision for the business." He defined this process as ". . . .the hard work involved in establishing an identity for the business which distinguishes it from competition. This identity, this knowledge of self, can then be used dynamically and aggressively as a focus to pinpoint markets, competition, and resources in terms of the pivotal entrepreneurial decisions currently needed, and any model of a business constructed without consideration of this input is likely to be a creation that responds only defensively to the environment."

Since growth is a natural objective inherent in this process, we should determine how that growth is to occur. Plans should be laid for internal growth, and if desired, external growth. Internal growth plans should be made in terms of:

1. continuation of current products and services
2. diversification and broadening of product lines and services
3. vertical integration
4. divestments of unprofitable or marginal product lines or operations

External growth plans should be made in terms of synergistic acquisitions or amalgamations.

Inherent in this determination of the future corporate profile is its financial stature. We thus should next ask ourselves questions about our planned posture in terms of:

1. profitability
2. return on investment

3. liquidity, leverage and cash flow
4. allocation of resources
5. debt structure and sources of working capital

We should *not* ask ourselves these questions relative to a point in time that represents only the end of the next fiscal year—but we should ask them relative to three years from now, five years from now, and even ten years from now. In other words, instead of just getting somewhere accidentally, let's decide *now* where we want to be out there in the future, then set down incrementally-phased plans on how to get there. So, instead of starting with 1972, for example, and working forward, let's start with 1981, or 1976, and work backward in terms of a definition of business purpose and financial performance.

But at the same time, let's *not* delude ourselves into thinking that circumstances cannot change. Let's not get into the "static-planning syndrome." So let's also develop alternate plans of action, because if a course of action is not working, the enterprise should have the ability to shift directions.

CRITICAL FACTORS

Now that we have an idea of where we want to be, what it will take to get there, and have defined broadly the framework in which we will operate, let's next identify the activities that we judge to be critical to the long-term success of the business. It is extremely important that this step be taken next, since objectives are needed in every area where performance and results directly and vitally affect the survival and prosperity of the business. The imagination and depth of thinking with which this is done will largely determine the quality of the whole planning and control process.

This part of the program should then be broken down into two parts. First, we should isolate the critical factors on which success of the business depends. Usually, this will consist of only a half a dozen factors or so. These are the activities that have a significant impact on short-term growth and competitive strength. They are the factors that are of such continuing significance that the breakdown of any one of them for a sustained period would, at best, impair earnings and industry position and, at worst, put the company out of business. Second, we should break down each factor into its profit-making components. These are the important elements of performance that have to be controlled individually to insure satisfactory overall results. For example, if we had chosen "marketing effectiveness" as one of our critical factors, we might break that down into four categories: share of market, number of outlets, profitability of the mix of products sold, and strengthening our distributor organization.

There are obviously more than half a dozen facets of the business that should be identified and monitored, but primary emphasis and attention should be devoted to these few that really count.

TRANSLATING BROAD GOALS TO INDIVIDUAL GOALS

What we have done so far is vital and essential, but obviously it is not yet specific enough for the comprehensive development of a dynamically responsive financial planning and control program. What we must do next is to translate the broad corporate goals into individual goals.

Before we can do this, however, certain basic foundations must be laid that will enable the plan to succeed. Without these, what I call "foundations for planning and control," the program will have less chance of succeeding.

1. Role of Parent Company

   A. If divisions or subsidiaries are involved, a determination should be made as to whether the parent will function as an investor-holding company or an entrepreneurial-operator-director company.

   B. The total organization should be well defined.

   C. A proper matching of authorities and responsibilities should be made.

   D. Timely, simple, and viable channels of communication should be opened and diligence should be exercised to insure that they are maintained.

   E. The organizational profile should not be structured simply to fit an existing information system. Preconceived notions, "sacred cows" and pride of authorship should not be allowed to stand in the way of the development of a viable structure.

   F. Definitions should be clearly established such as the role that both top management and lower levels of management are to play, and the interfacing of both. Also needed is a clear interpretation of information that is to be inter-communicated.

   G. The roles of sub-operators should be clearly defined showing authorities and responsibilities and communication and interface with top management.

H. The degree of autonomy to be allowed must be determined. In doing this, determination should be made as to how deeply the decision-making process should be taken. Autonomy should not be permitted to the point of loss of control.

I. Top management should *also* not permit itself to "over-meddle."

J. Foremost concern should be the well-being of the firm as a whole.

K. Continual exploration should occur concerning potential synergistic opportunities within the total organization.

L. Corporate executives should become familiar enough with subsidiary operations so as to become "snow-proof."

M. Divergent policies and practices within the total organization should be located and eliminated. Discrimination for or against one subsidiary at the expense of another should be eliminated.

N. Policies should be adopted that will allow the parent to consistently be a fair and impartial umpire when required.

O. A unified and consistent picture of the company should be presented to outsiders.

P. Unrealistic goals should not be placed upon subsidiaries.

Q. Corporate staff should play only the role of advisor to corporate management, and never the role of decision-maker for subsidiaries.

R. Corporate line executives should be imbued with certain basic responsibilities and authorities, where necessary, to achieve a coordinated and unified approach among subsidiaries.

S. Corporate policies must be flexible enough to accommodate any differences in the operating modes of each subsidiary. A determined effort must be made to first insure that such differences really do exist.

2. Role of Subsidiaries

A. Foremost concern should be the welfare of the total entity rather than the subsidiaries' personal well-being.

B. Constant communication is necessary to keep the parent informed of current and potential conditions and problems.

C. Any fear of asking the parent for help when required should be eliminated.

D. Constant growth of the organization should be the goal. This can be aided by eliminating any reluctance by a subsidiary to move good people to other parts of the organization.

3. Short-Term & Long-Term Planning

A. A central coordinating body should exist for planning.

B. Responsibility for planning should be assigned to those people in the organization who can bring expertise and good judgment to bear. Top level support for such people is a must.

C. All levels of management should be allowed to take an active part in the planning process.

D. Planning should not be made just for "planning's sake," but should contain definite and desirable goals and objectives.

E. Goals should be established that are realistic and obtainable, but obtainable only through effort. Loose goals are self-defeating.

F. Time-frames and bench marks should be established for the setting and carrying out objectives. It may not be practical to try to do everything the first year, or by the second year, or even by the third.

G. A realistic system should be established to allow intelligent judgment concerning allocation of corporate resources.

H. Operating, marketing and financial plans should be fully coordinated and integrated.

I. A forward look should be taken as to what the planning and control system should ultimately look like. In doing this, present organizational structures or systems should not be allowed to hamper the ultimate needs. A "building-block" approach should be taken to insure later compatibility and the planning process should never be viewed as static.

J. The system should provide for common measurement of the different entities.

K. Consideration should be given to many financial and operating strategies including financing plans, operating budgets, resource allocation/capital budgets, annual profit plans, long-range business plan (five years or more) and forecasting systems.

L. Methods should be developed for challenging existing plans.

4. Financial Controls

A. The need for a dynamically responsive and timely information and control system is of prime concern. Research should be undertaken to determine each of the requirements for such a system. Determination should be made as to what changes will be required to obtain the desired system and also how long it will take to achieve these changes. The plans should provide for interim tools until the basic system can be achieved.

B. A management by exception concept should be established. Determination should be made of critical measurement indices for each entity. Concentration should be placed on the major issues and diverted from the minor ones. The organization should be structured so as to achieve a pyramid reporting concept. Care should be taken not to "over-layer" and not to structure spans of control that are too large.

C. Performance measurement should be established for sales, profits, return on sales, return on assets employed, return on equity and others.

D. A system of rewards and penalties should be established that is tied to performance. Such a system would provide for proper matching of authority with responsibility. The system should be able to separate non-controllable variances from controllable ones. True performance should be measured on improvement from the point of responsibility assumption, regardless of past history or current situations. The system should be able to identify post-effects of inherited situations.

E. Consideration should be given to how the parent will finance itself. If outside borrowings are resorted to, a determination should be made as to what charges will be made, or paid, for the use of cash. Consideration should be given to the upstreaming of cash to the parent by subsidiaries in the form of dividends, Federal income taxes, debt repayment, interest expense, corporate general and administrative expense and corporate services specifically provided to subsidiaries.

F. A corporate analysis and control function should be established. Consideration should be given as to how this organization will be formed and structured and to whom it will report. True independence is a critical factor. Consideration should be given as to what role it will play in the total organization.

G. System upgrading is required and long-range plans should be established. The system should be kept flexible and responsive and should be continually upgraded.

Having laid this basic foundation, we can now proceed to develop, first, individually integrated goals and, next, systems of measuring performance against these goals. I use the word "systems" only in the context of the concept of cybernetics, which is the science of communication and control. I feel that the word "system" is a grossly overused one, and one which is easily misinterpreted or misunderstood. Many people labor under the delusion that systems control costs. They don't–people do. The system is only a tool to this end. Many people *concurrently* think that control tools measure performance of systems. They don't–they measure the effectiveness of people.

Broad company objectives are usually determined by top management. Before this can be done, however, top management needs all of the information that can be obtained on all essential factors.

Once the facts have all been collected and interpreted, and the basic foundation has been laid, management is ready to translate the overall corporate program into departmental and individual objectives. Here, the emphasis should be on participation by all levels of management to whom the objectives and standards are applicable. The participation of the subordinate and the superior in setting, reviewing, and revising objectives and standards is all-important. This is because participation increases commitment; commitment heightens motivation; motivation makes people work harder and more productively; and more productivity enhances the organization's prosperity; therefore, participation can have a very positive effect on results.

One other important facet to remember about objectives and standards of performance is communication. The importance of communication–the complete and timely transmission of valid information–should be recognized in all aspects of this effort. The participation of the man and the supervisor in all phases of the objectives and standards activity should be designed, in part, to produce effective information exchange.

TRANSLATING AND INTERPRETING THE GOALS

A budget is a measuring device. It is also a means of extending plans in detail and communicating the standards that must be met if the plans are to be realized. Having set basic objectives and standards, we can now test their reality by extending them in budgets. If the evidence indicates that the objectives and standards are not realistic and feasible, they will be revised. We now have a "closed feedback cycle," in this case the cycling of plans through "model testing" and re-planning. This all occurs before actual performance. As the results of performance are known, a similar recycling takes place.

Results are usually known through some form of information system. This system should be tailored to fit the informational requirements needed in order to correctly interpret performance against the goals—never the other way around. Objectives and standards of performance will serve as an effective guide to individual managers only if the results of their efforts are revealed in timely and accurate information for their use in the evaluation process. And it does not have to be a complicated system—in fact, the simpler it is, the easier it will be for it to function, the easier it will be to understand, and the easier it will be to make effective use of the information that it generates.

CONCLUSION

Obviously, the end result of all of this should be the attainment of the goals that the organization has set for itself. The best designed set of long-range goals, the best designed set of short-range objectives, and the best designed system of reporting results against these goals and objectives will be of no value, and will have been a waste of time and money, unless intelligent decisions are made based upon the information that all of this provides. This one important fact should be kept uppermost in the minds of all who set out on such an endeavor. ●