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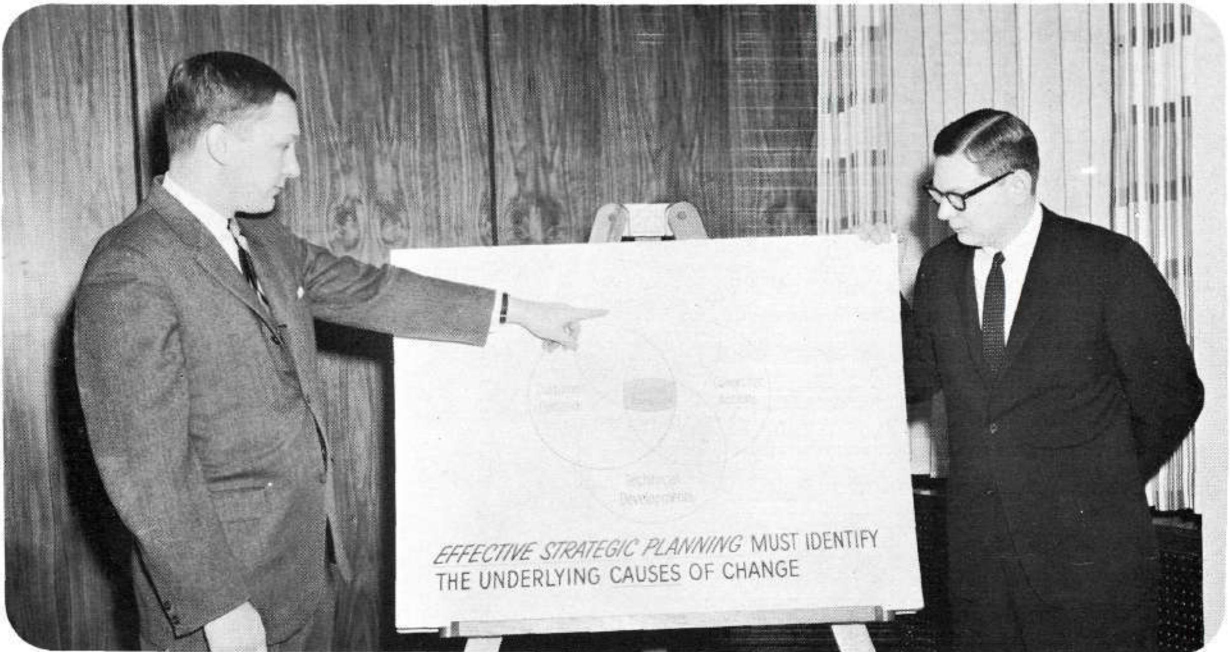
FORMAL BUSINESS PLANNING

by Donald A. Curtis and James M. Edgar



James M. Edgar, senior consultant in our Detroit office, joined TRB&S in 1964. His experience includes projects in market potential analysis, retail site selections, incentive compensation plans and systems planning and he is a frequent speaker on the subject of corporate planning. Prior to joining TRB&S Mr. Edgar was employed by a major chemical company where he participated in their marketing activities. Mr. Edgar holds a Bachelor of Chemical Engineering degree and a Master of Business Administration in accounting from Cornell University. He is a member of the American Marketing Association and the Economic Club of Detroit.

Donald A. Curtis, partner in our Detroit office, has been with TRB&S since 1957 and has participated in a variety of engagements involving the corporate planning function. Currently he is the national management services program director for corporate planning and has responsibility for a variety of specialized projects in organization, inventory control, management reports, pricing, systems planning, production scheduling and computer feasibility. Mr. Curtis holds B.S. and M.B.A. degrees from Wayne State University. He is a member of the Michigan Association of Certified Public Accountants, American Institute of Certified Public Accountants, Institute of Management Sciences as well as the Economic Club of Detroit.

FORMAL BUSINESS PLANNING

Some businessmen remember the "Great Depression." Most businessmen remember the last "recession." All businessmen think about tomorrow. As they think about tomorrow their reference points are, of a necessity, today or yesterday but mostly "yesterday." Those whose yesterdays are a little older — a little longer ago, are able to reflect more accurately upon the great and magnificent changes that are taking place now. On a comparative basis they can see more clearly that change is taking place at an accelerating rate. Increasingly, therefore, the job of company management is *the management of change*. This job may involve anticipating and reacting to changes caused by others outside the company *or* it may involve identifying and implementing those changes which the company can profitably cause itself. No matter what the job involves, however, it requires formal planning to be most effective.

Company objectives and company strategies are the principle subjects in any discussion of a formalized approach to planning.

- Company objectives are those targets which the top management group sets for its company. These objectives include everything of major concern to the top management group.
- Company strategy describes in broad terms how the top management group expects to utilize company resources in achieving company objectives. It is the core idea behind company action.

Taken together, company objectives and strategy define a framework for company planning and action.

COMPANY OBJECTIVES

Company objectives direct or limit company activities. They should be written and quantified (where possible) both for understanding and control. At the discretion of management, objectives may be set on a variety of subjects such as the following:

- Earnings
- Dividends
- Cash flow
- Growth rate
- Dollar sales
- Market share
- Return on investment
- Degree of market coverage
- Capital structure
- Degree of integration
- Degree of diversification
- Nature of management group
- Nature of ownership

Discussions of business planning place considerable emphasis on the setting of attainable company objectives. Objectives are important but this emphasis on setting objectives is misleading. All that is needed is a statement of desirable company objectives. Whether these objectives are attainable will become clear later in the planning process, as specific alternative strategies are evaluated.

COMPANY STRATEGY

How management achieves company objectives is a matter of strategy. Strategy is action oriented. It is strategy which should receive major emphasis in the planning process.

Management must deal with strategy in three ways in the planning process: First, alternative strategies must be developed; second, alternative strategies must be evaluated and the best selected; and, third, the selected strategies must be implemented.

DEVELOPING ALTERNATIVE STRATEGIES

To develop alternative strategies, management must work to perceive change. In particular, it must understand these external factors:

- Trends and shifts affecting the economy
- Technical developments affecting company products and processes.
- Changing competitive activity affecting the market share of the company
- Changing customer demands affecting the markets of the company

An accurate understanding of these factors leads to an identification of the opportunities and the threats confronting the company. These opportunities and threats, in turn, provide the stimuli for developing alternative strategies. To exploit opportunities, a company needs offensive strategies; to combat threats, defensive strategies. Moreover, the company on the defensive must consider how to shift from defensive strategies to offensive strategies.

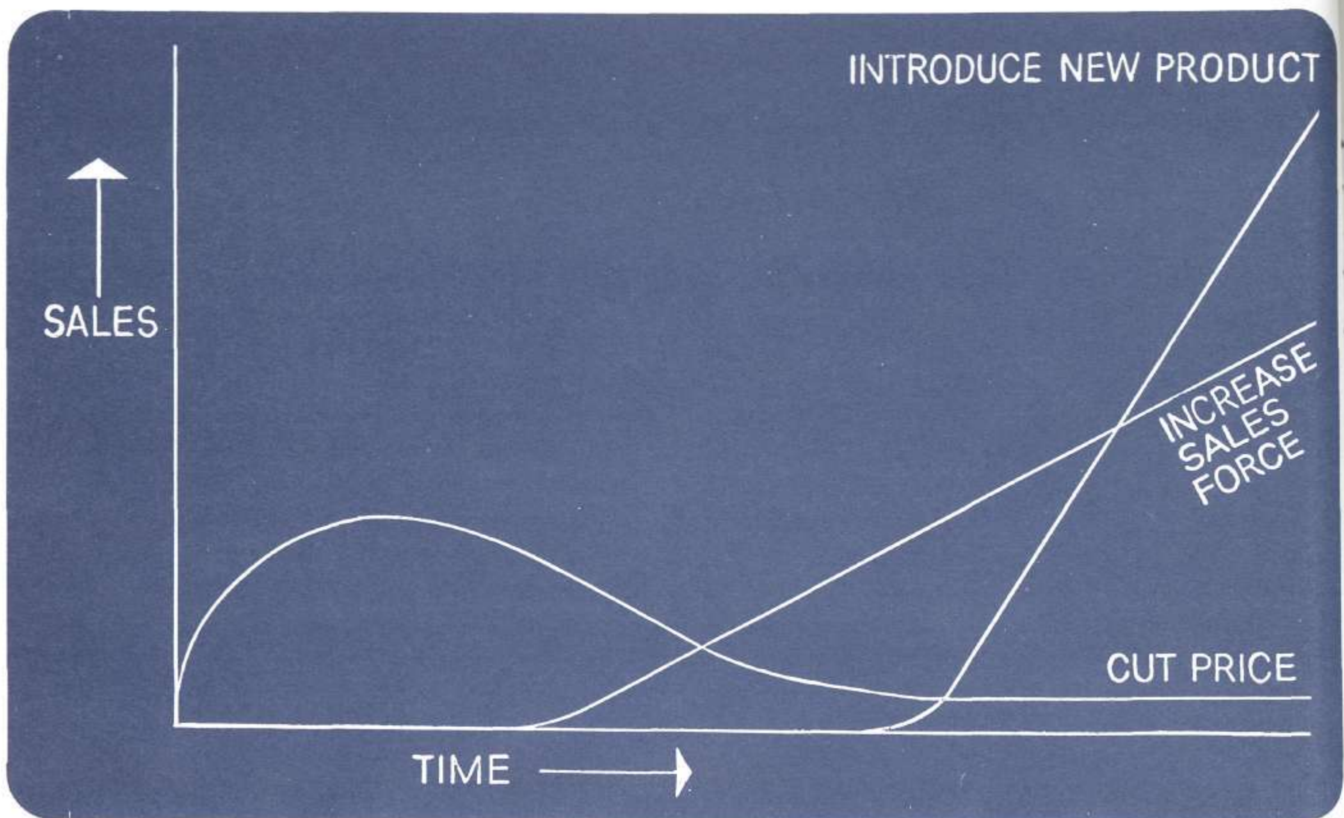


Fig. 1.

In attempting to perceive change, management must have, and usually does have, adequate information regarding the internal operations of its company. However, it frequently does not have sufficiently sound data regarding the major external factors which effect changes in those operations. Information on competitors is a typical example, for seldom is it studied systematically. Yet, if carefully reviewed, trade publications, newspapers, magazines, advertisements, financial statements, and credit reports can provide considerable insight into competitive activities. Additional information can be obtained from salesmen and customers as well as from market research. Some of the competitive data which may become important in planning are:

- Changes in market share
- New products
- Price changes
- Credit policy revisions
- Discount modifications
- New outlets or facilities
- New advertising campaigns
- Manufacturing innovations
- Recent acquisitions
- New financial backings
- Major personnel changes

The importance of systematically developed information on all external factors cannot be overemphasized. The foundation of business planning is the information upon which it is based.

The development of alternative strategies is the creative step in the planning process. At this point, the planning process is much like the top of a funnel. It is in the company's best interest to make the diameter of that funnel as large as possible by considering *all* of the alternative strategies that the company might undertake. Frequently, management identifies only a few of the strategies available to it.

For example, if a competitor were to introduce a new product in a profitable company market, some of the alternative strategies would be:

- Do nothing
- Increase company advertising
- Decrease price on company product
- Reduce manufacturing cost
- Increase field sales force
- Increase level of customer service
- Improve quality of existing product
- Drop existing product
- Introduce new product
- Buy out competitor

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
FACILITIES	[illegible]	[illegible]	[illegible]	[illegible]	40% INCREASE IN MANUFACTURING CAPACITY
FINANCES	[illegible]	[illegible]	$2,500,000	[illegible]	[illegible]
ORGANIZATION	1 SALES MGR. 15 SALESMEN	[illegible]	[illegible]	[illegible]	[illegible]
PRODUCTS-MARKETS	[illegible]	[illegible]	3 NEW PRODUCTS	[illegible]	[illegible]
SYSTEMS	[illegible]	INCENTIVE COMPENSATION PLAN	[illegible]	[illegible]	[illegible]

SIZE OF GAPS and METHOD OF CLOSING

COST AND INVESTMENT

Fig. 2.

- Diversify into new fields or markets
- Sell out company

Several key points can be developed from this example. First, each of these possible strategies could be a reasonable response to the threat that has been identified. The appropriateness of some may be more obvious than others. For instance, reducing manufacturing cost may be a valid strategy for a company trying to remain profitable at a lower volume caused by the competitive product. All too often a management considers only a few of the possible strategies with no assurance at all that the strategies being considered are the best available.

Second, the selection of the best strategy from the alternatives is usually not obvious at all. Often, however, management will seize upon one which attracts its interest without any real knowledge of whether it is best from the standpoint of its objectives. Management probably feels better doing something when doing nothing could be the most profitable strategy of all.

Third, many of the alternative strategies could be combined. Benefits derived from a skillful combination of two or more alternatives may produce benefits greater than the sum of those which would have resulted individually. Unless management has first identified the alternatives, it cannot explore ways of combining them.

EVALUATING ALTERNATIVE STRATEGIES

Each alternative strategy must be analyzed systematically to determine the probable gains which will result from its adoption, the corporate resources which are required and the risk to be encountered. When each alternative has been analyzed, it can be compared with the other strategies and with the company objectives. The actual selection process is straightforward, but not necessarily easy.

Probable Gains The first step in analyzing each strategy usually involves forecasting the incremental revenues which would be likely if that strategy were implemented. The revenue forecast is based on the anticipated reactions of customers, competitors, employees, or government, as appropriate. Different strategies have different impacts over time as shown in Figure I. Some strategies, such as price cutting, may produce immediate results. Others, such as increasing the sales force or introducing a new product, may require lead times of various lengths before results are produced.

A skillful combination of strategies with near term, intermediate term, and long-term payout is essential for effective planning. As a practical matter, *a distinction between long-range and short-range planning may be*

unnecessary or even harmful, for two reasons:

- First, at any point in time, a company has a wide range of alternative strategies available to it, each with a different lead time and flow of benefits. Selection from among these alternatives involves some sort of balance between near term and long-term benefits. Action taken near term precludes certain longer term actions for a company with limited resources, e.g., a massive advertising campaign now or a new plant three years from now. Therefore, the short-term or long-term nature of the strategy often cannot be distinguished in the selection process, particularly for a small or medium-sized company.
- Second, both short-range and long-range strategies usually require action in the short range. Indeed, a major purpose of formal planning is to make sure that *all* the required short-range action will take place, not just that portion necessary for short-range results. Companies often encounter difficulty because the first action steps in implementing a long-range strategy are never taken.

Resource Gaps The second step in analyzing each strategy is an identification of those resources that would be needed in the implementation. For some strategies, those resources will already be available within the company. In other cases, they will not. When they are not, a *resource gap* has been identified. The size of the resource gap and the method used to plan it away largely determine the cost and investment required to implement the strategy.

Consider, for example, the resource gaps which might be associated with an increase in company sales force, as shown in Figure II. In the organizational area one sales manager and 15 salesmen might be needed now. In the facilities area, a 40% increase in manufacturing capacity might be required in the fifth year because of incremental sales expected from the expanded sales force. In the financial area, 2.5 million dollars might be necessary in the third year to finance increases in manufacturing capacity, receivables and inventories. In the product area, three additional products might be needed in the third year to provide a broader product line for the expanded sales force. Finally, in the systems area, an incentive compensation plan might be deemed necessary by management to reward salesmen on the basis of the profitable sales which they generate.

The size of these resource gaps and the method by which each is planned away largely determines the cost and investment associated with this increase in sales force. The fact that manufacturing capacity must be increased by 40%, not by 100%, has an obvious effect on cost and investment. The method by which manufacturing capacity is increased is also important. Consider the likely impact on cost and investment of these possibilities:

- Expand existing plant
- Build new plant
- Contract manufacture
- Acquire company
- Launch joint venture
- Increase price (this, avoiding the problem entirely, perhaps)

Risk The third step in the analysis of each strategy is a review of its inherent risk. This is admittedly the most qualitative step in the analysis but it is one which can be performed systematically. Several elements affect risk.

First, risk is affected by the sensitivity of the forecast to events which are not expected. The more sensitive a forecast is to unanticipated results, the more risk will be involved. Profitability of a new product, for example, may be predicated upon a research and development effort remaining completely secret from competitors until commercialization. Of course, competitors may learn about company research efforts and begin to react to them before the actual product launch. The effect of this possibility should be evaluated.

This sensitivity analysis identifies those key factors which, if they do not occur according to forecast, will drastically affect the results of the strategy. Intelligent management recognizes the importance of such factors and watches them closely during the implementation of the strategy.

Flexibility is the second element affecting risk. The more flexible a strategy can be made, the less risky it will be. Flexibility is important because the strategy may be unsuccessful or the opportunity—or threat—may change, thus making the original strategy obsolete.

The third element affecting risk is the degree to which a company must commit its base of power in order to implement the strategy. The smaller the commitment, the smaller the risk of the strategy. Every company has a base of power made up of its various resources, including finances, facilities, organization, products, markets, technical knowhow, and even image. Implementing a particular strategy requires some commitment of these company resources and, therefore, a part of the company base of power. If the size of the commitment is high, a company may be faced with dangerous exposure should

the strategy not produce the expected results. For example, a company utilizing all of its available capital to build a plant may jeopardize its very existence if that product is not successful or if the plant itself cannot be sold or modified.

The implementation of any strategy should be undertaken as a *creeping commitment* in order to minimize risk. During the early stages of implementation, the commitment of the company base of power should be as small as possible. Additional commitments should be made only as the likelihood of success increases. Thus, a company requiring additional manufacturing capacity for a new product might contract out some manufacturing until the long-term success of that product is more certain.

The fourth element affecting risk is the uniqueness inherent in the strategy. Uniqueness in this sense means competitive advantage or unique selling proposition. It is that aspect of the strategy which is different from the present or likely offerings of competitors. A Corvair car would be an excellent example of such uniqueness. This car, like the Falcon, Comet, or American, was a compact car. It differed from all others, however, in having its motor in the rear. This difference alone insured an element of uniqueness for the Corvair which still has not been duplicated.

The impact of uniqueness on risk is difficult to assess. Greater uniqueness does not automatically mean either greater or less risk.

SELECTION PROCESS

From this analysis of revenues, cost, investment, and risk, each strategy can be compared with the alternatives and with company objectives. If company objectives are unattainable, that fact becomes apparent at this point in the planning process.

Selecting the best strategies from the alternatives, however, is not easy even after careful analysis. It is difficult for two reasons:

1. Company objectives themselves may conflict, not in obvious ways but in subtle ways which become obvious only after the analysis of specific strategies. A profit objective, for example, may be unattainable if a diversification objective is achieved.
2. Risk is extremely difficult to balance against expected benefits. How does one really compare a high risk venture with large potential benefits and a much less risky venture promising much smaller benefits?

Resolution of these two dilemmas is the essence of management. It is management's responsibility to establish priority among company objectives and to determine the degree of risk to be undertaken by the company.

IMPLEMENTING THE SELECTED STRATEGIES

Strategies are translated into working plans which consist of goals and the appropriate programs of action, each assigned to specific individuals within the company. These plans become the basis for both action and control.

In a large company the specific goals and programs of action would probably not be developed by the top management group. This group would state company objectives and strategy for key operating executives who would be responsible for developing goals and appropriate programs of action within their own organizations.

Top management or its planning staff would review the working plans for completeness, consistency, and realistic relationships between the planned actions and the anticipated results. The degree of planning detail would depend primarily upon the size of the company and the complexity of the strategies selected for implementation.

The planning process provides management with a much broadened basis for control since it deals with both the results *and* the actions causing those results. It plans both profits and actions. The profit plan provides a standard by which actual results are evaluated; the action plan provides a similar basis for assessing actions. The profit plan deals with what is to be accomplished; the action plan with how it is to be accomplished. Action planning is particularly important as a control device when the lead time is long between action and results.

SUMMARY

The Management Information System has the continuing job of translating economic shifts and trends, technical developments, customer demands, competitor actions and results of company operations into description of opportunities and threats. These opportunities and threats should be reviewed at appropriate intervals by management while it considers four key questions:

- Are new company objectives needed?
- Are new strategies needed?
- Are new plans needed?
- Are planned actions actually taking place?

The answers to these questions determine whether management must develop new objectives or strategies or plans, whether it must take corrective action because plans are not being complied with, or whether it should let company activities continue as planned. In short, the answers to these questions determine the need for additional formal planning at any point in time.