

CFO insights: Capital budgeting in the downturn: Four disciplines

The credit crisis and the rapid deterioration in the global economy have left many CFOs scrambling to cut costs and reprioritize budgets. Cash is king for now and finance organizations are scrambling to:

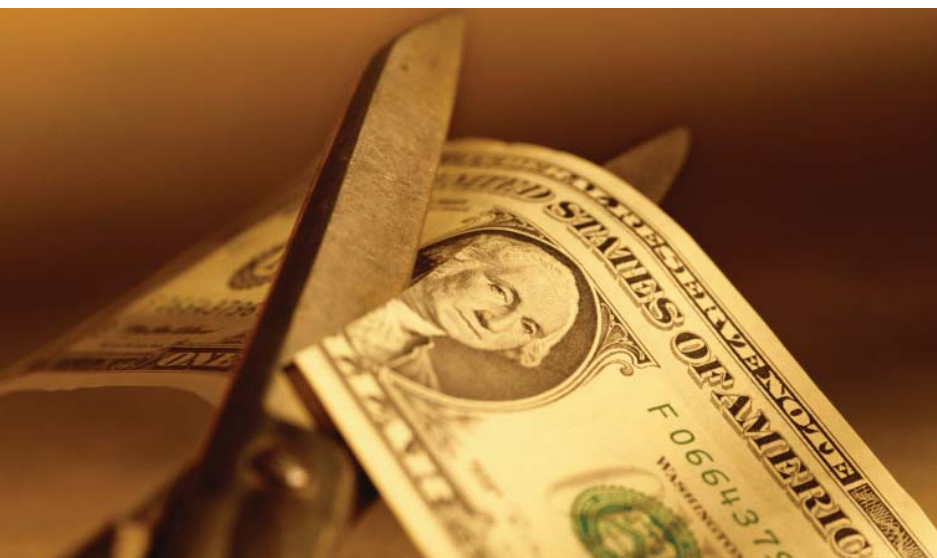
- Better forecast cash flows in and out of the company
- Reprioritize projects to rejuvenate cash inflows in the near term
- Reprioritize projects to balance long-term capital plans and strategic goals with near-term cash flow and cost reduction objectives
- Prepare the finance organization for a paradigm shift in budgeting for the future

All of this is being done as finance organizations are under tremendous pressure to downsize. The credit crisis beginning in 2008 marked a turning point in the global economy. After living in a world of easy credit for years, companies won't likely have guaranteed access to short term cash at favorable terms in the foreseeable future. Now, and possibly for years to come, they will have to budget for and align cash inflows and outflows to capital investments much more carefully. Executing the alignment between the long-term goals of capital planning and growth, and the current situation has probably never been so difficult. The current climate calls for a much more robust situational analysis, juxtaposing the demands of both short-term cash needs and long-term capital planning: if we cut capital here what does it do to cash, operating costs, long term structure, and the ability to rebound when the economy recovers?

Leading CFOs will use this crisis to get budgeting and planning in their companies better aligned with the new cash driven realities. Outlined here are four disciplines CFOs can quickly execute to improve budgeting for projects in the downturn. Future papers will address the topics of improving forecasting, valuation and assessment of benefits, and transforming the budgeting system.

Quick and smart downshifting

Anyone who has lived through a prior recession has likely experienced the budget fire-drill, when corporate finance and budgeting groups request an across the board budget cut of ten, twenty percent or more to reduce costs. Managers are left to scramble, reduce headcount and cut projects. Such a decentralized approach to cost reduction is often built on the premise that local managers know best how to cut costs close to them in their organizations



and get the greatest return. This is partially true, but could also dramatically undermine the future success of the company. Local managers may not always realize the interdependency among projects; a low priority for one manager may be a very high priority for another, and thus cuts in one area can delay and disrupt high value and critical projects that demand resources from multiple areas. This is especially the case with large complex capital projects. Often these projects go off the rails at considerable costs due to poor management of project interdependence across groups.

So what should CFOs and budget directors focus on now? What should drive the triaging of projects and what should they demand of line managers? In the short term, there are a number of disciplines CFOs and budget directors should undertake to rebalance their portfolio of projects and manage to the cash needs of the moment.

1. Clean Sheet Budgeting – With any number of projects in various stages of completion, the starting point of triaging efforts is to realize that “sunk costs” and prior expenditures are exactly that – “sunk.” All that matters is cash flow going forward and the expected revenues and benefits and the time frames for realizing those benefits. There should be no sacred cows because of prior expenditures – all that matters is what the expected return is from an extra dollar to be invested tomorrow. All projects should be quickly reassessed with a clean sheet.

Example: A global mining company had 25 major capital projects in the queue. In evaluating one of the top five projects – a major new mineral processing facility costing over \$100 million – there were interdependencies with an adjacent mine already in operation. Since the current mining operation served as a “feeder” to the new processing facility, it made strategic sense to view them together. But from a budgeting perspective, the current mine and the infrastructure it shared with the new processing plant were sunk costs. Because the shared infrastructure had been built in the prior year, the clean sheet perspective focused just on marginal costs and benefits. The team also divided the capital plan into two phases, leaving

the second phase decision (expansion of the plant’s capacity) until a future year once the company learned about the attractiveness of commodity prices and the success of new technologies being deployed at the plant. The clean sheet perspective improved the ROI and risk management of the project, and reduced the current year capital expenditures by almost 20%.

2. The Shortest Time to a Positive Benefit

Discipline – Under the old model of budgeting, the approach was to invest in all projects with a positive discounted cash flow, especially those with the highest return. Payback periods as a project selection criteria fell into disrepute for not selecting the highest value opportunities. Today we need to reconsider the time to a positive cash flow. What are the positive net present value projects which will also generate the quickest cash savings or net positive new revenues? Can these projects be completed in the next three to six months to create a positive cash impact? If so, managers would be well advised, particularly in the current environment, to execute a subset of these quick hit projects now. As cash becomes more available, payback periods can be extended.

Example: A global financial services company was shifting project priorities to emphasize near-term benefits and cash preservation. The finance and IT organizations had previously measured and ranked the benefit-to-cost information for over 100 systems projects being evaluated. The list was re-prioritized with more urgency placed on projects from which direct financial benefits (revenue growth or cost reduction) was expected to materialize within the next 12 months, and for which expenditures were primarily “soft” costs (e.g., allocating current employees to a project) rather than “hard” costs (e.g., cash paid to external consultants or to hardware and software vendors). About 1/3 of the projects were approved for implementation in the current year, another 1/3 were deferred for reconsideration in the next funding cycle, and the remaining 1/3 were rejected. The results produced visible traction for the organization’s IT initiatives while saving over half of the planned cash expenditures.

3. The Less than 100% Budget – When new budget requests are made, it is important to consider alternative scenarios for a project such as, what can be accomplished and in what timeframe with 70%, 80% or 90% of the proposed budget. This standard helps to avoid gold bricking and forces managers to consider lower cost alternatives to accomplish a goal. For the requestor it may also increase the likelihood of an approval. For projects that might otherwise be considered too expensive, the less than 100% budget proposal may create cash flows and options for the future that the budget committee can approve. This is a good budgeting practice that leading companies often use, and it is especially critical now as CFO s look to cut costs and realize new efficiencies.

Example: An electric utility company was under pressure to reduce operating costs and trim the capital budget. Department heads were accustomed to presenting their full wish list when asked for their department’s capital budget. Using a more disciplined project portfolio approach, the finance team requested that department heads provide two or more lower alternative funding versions of their budget requests. The message given to them was: the more alternative funding levels they submit for their department, the more likely they will receive some funding; however, if they only submit the “gold standard” it is unlikely they will receive any funding. The finance department then had much more flexibility in allocating a constrained capital budget across multiple departments in a manner than delivered more “bang for the buck.” The reduced portfolio delivered a 25% improvement in overall ROI.

4. The Discipline of Deferral – As budgets are cut, some projects will inevitably be delayed. How are expected project benefits impacted by delays? Projects where benefits drop off dramatically could probably go on the chopping block. But, for projects where benefits are most likely to accrue later, consider whether significant cash outlays can be deferred until later when the immediate credit crisis is less pronounced? Another consideration is whether deferral of projects creates any specific risks such as violating regulations.

Assessing the impact of delays, and mapping different timing alternatives for cash outlays can also help budget directors better balance cash outlays on major projects with expected cash inflows.

Example: A healthcare company was looking for efficient methods to reduce the capital budget for the current year. They reexamined the portfolio of projects with a new lens. They considered a number of factors, including whether the projects were driven by a regulatory mandate and whether there were less costly options for meeting the mandate, what the impact would be if the project was deferred by a year or if the project was rejected outright. By asking these opportunity cost questions, they gave themselves alternatives for optimizing their portfolio. If two projects are of equal value in all other aspects, and if they are deferred by a year, one project might be significantly hurt (e.g., the opportunity to beat competition to the market with a new offering will be lost), while another project might simply achieve nearly the same level of benefits but these benefits occur one year later (e.g., a data warehousing initiative). Then the project likely to suffer the most from a deferral should be giving funding priority. By introducing the extra question or two in a business case template (what is the opportunity cost of deferral or rejection?), the finance department has much more flexibility to make the most efficient use of scarce resources. The new approach helped identify a portfolio of projects that delivered nearly 30% more expected value over the portfolio that was initially identified through more informal approaches with an identical budget constraint.

Line managers and finance functions are likely to find the budget downshifting process challenging. Often information may not be easily available and re-calculating benefit and cost estimates can be another challenging effort in the time of a crisis. Indeed the recession and credit crisis are likely to expose how broken budgeting, forecasting and planning are in most organizations.

Nevertheless these four disciplines: clean sheet, quickest to benefit, the less than 100 percent budget and deferral, can help quickly identify which projects to keep and which to terminate as companies struggle with conserving cash in the short term. Focusing on the big ticket capital expenditure items and going through these disciplines step by step can help to identify the largest cash-saving opportunities quickly. In the near term, these four disciplines allow for a smarter downshifting over indiscriminate across the board cuts, and serve as a starting point to prepare for a broader realignment of budgeting and planning processes toward better aligning cash flows and capital outlays to corporate strategy. While it will take time to build systems to fix the broken budgeting and planning process in many firms, our companion papers in this series will consider how to build from these first steps to a better budgeting discipline.

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