PROFITABILITY ANALYTICS CENTER OF EXCELLENCE

eBook

How to Better Manage Strategic Investment



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STRATEGIC MANAGEMENT

An organization's investment management process should be part of its strategic management framework, which encompasses:

Strategy formulation - where an organization establishes its plan for identifying and addressing its market(s) and for mobilizing, adapting, or acquiring resources and capabilities to meet the demands created by that plan.

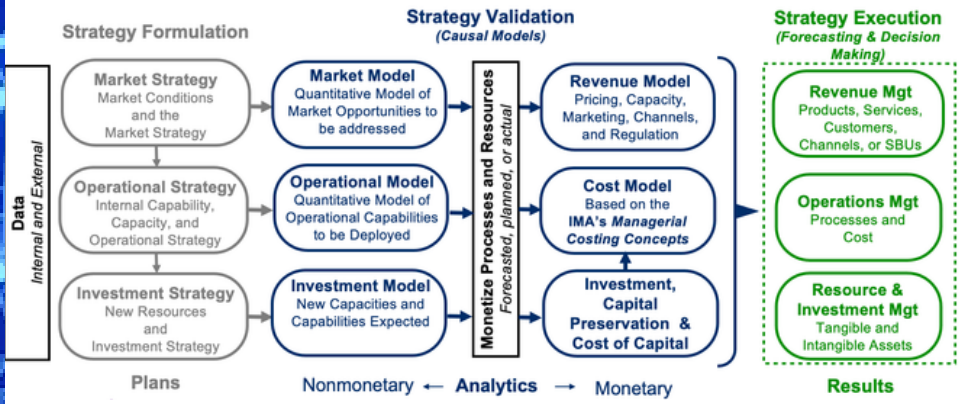
Strategy validation - where causal models are developed that directly enable the evaluation of strategy. These models employ the principle of causality to quantify, in operational and monetary terms, the revenue and cost impacts of an organization's strategy, and then track the execution and performance of that strategy.

Strategy execution - involves decision making that employs the outputs of the causal models to provide organizations decision makers with the accurate and relevant information they need to make economically sound decisions as they execute and adapt tactics to meet strategic goals.

PACE PROFITABILITY ANALYTICS FRAMEWORK (PAF)

The PACE Profitability Analytics Framework (PAF) supports and enhances the strategic planning process of an organization by going beyond traditional financial accounting, reporting, and analysis. It incorporates modern revenue management techniques, modern managerial costing focused on internal decision support, and new views on investment management. This eBook focuses on the last of these, describing investment management as envisioned in the PAF as organizations progress through their strategic management process.

As shown in the figure below, the PACE PAF addresses an organization's investments in each stage of strategy management. Each of these are discussed in turn below.



STRATEGY FORMULATION

Formulating an organization's strategy is a complex, innovative, and forward-looking process that requires a clear understanding and visibility of internal capabilities and processes, external environment and trends, and competitors and consumers. It begins with formulation of an organization's market strategy, which describes the current and expected conditions and opportunities in the market and the organization's plan to exploit those opportunities and capture value. It then moves to the development of an operational strategy, which describes the resources and capabilities available to the organization and how they are aligned to execute the market strategy, is then formulated. Finally, it will create an investment strategy, which will identify the gaps between the organization's current capabilities and resources and those that will be required to achieve strategic goals and identify options to address any shortfalls.

Investment strategy in an internal decision-support context must consider both tangible and intangible investments. Advertising, R&D, human resources training, process improvement, community and governmental engagement, and other expenditures are traditionally categorized as expenditures for financial accounting. Yet these expenditures, which often improve an organization's long-term capabilities, should be evaluated alongside traditional capital investments, and treated as having multi-year impact on an organization.

Strategic Investment

New investments can also factor into an organization's risk profile and strategy. Risk considerations can include variability in implementation time, risk of project failure, risk of anticipated demand failure, risk of missing an opportunity if demand is greater than projected, changes within the competitive environment, technological changes, new competitor capabilities, the stability or certainty of customer demand, and the potential to apply the investment capability (in whole or in part) to alternative uses.

"The essence of strategy is about making choices. One of the most tangible manifestations of those choices is in a company's resource allocation decisions. The PAF framework helps draw a clear connection between strategy and resource allocation and highlights the important role that analytics plays in bridging that gap."

Shane Goss, ASA
Business Advisory
Managing Director



INTANGIBLE INVESTMENTS

When thinking of investments, management accountants and executives tend to focus on the tangible investments that are capitalized on financial statements created in accordance with external financial reporting standards. This is often a mistake: in today's economy it has been estimated that as of 2020, 90% of financial market valuation is based on intangible assets.

The definition of intangible asset categories varies as business and investment professionals seek to understand the new knowledge and learning economy. The core criteria to consider is the long-term ability of an investment to develop organizational capabilities. Developing categories of intangible assets include:

Brand capital – creating and maintaining brands customers have confidence in, reputation

Human capital – recruiting and retaining personnel and enhancing processes to grow their capability/creativity,

Innovation capital – Research and development, process improvement, market/customer research, intellectual property

Data and analytics capital – digital strategy on how to incorporate these capitals into corporate/organizational capability, proprietary data, flexible architecture, rapid/adaptive implementation

One significant difference about intangible assets is that they often grow in value over time if they are effectively managed and "maintained." Many forms of intangible capital build on each other and grow in effectiveness and capability as they are used. Even failures are often looked at as an investment in organizational learning and future innovation.

In the PAF, investments in brands, human, innovation, and other intangible capitals are handled much like tangible capitals in planning, budgeting, costing, and evaluation. Investment planning should include both tangible and intangible investments that are expected to have a significant investment period followed by a stream of benefits or returns.

Example: an investment to upgrade a manufacturing line with new equipment involves equipment purchases, consulting fees, training, internal labor, IT changes, and many other expenses. All should be tracked when determining the amount of the investment and evaluating the return.

Example: An investment in process improvement involves training, consultants, use of production/service equipment, and internal labor, none of which are capitalized for financial accounting. These expenses and use of internal and external resources should also be tracked for determining the amount of the investment and evaluating their return.

Strategic Investment

Organizations have long had an operating budget and a capital budget; today's economy calls for more expanded definitions of planning. Using the PAF, investment strategy needs to consider traditional capital investment needs and also include brand investment, human capability investment, innovation investment, data/analytics investment, and any other intangible investment capability needed by an organization. Articulating specific categories of intangible investments can help leaders and managers think of the capabilities they need to develop to achieve their marketing and operational strategies and goals.

STRATEGY VALIDATION

The core of strategy validation is to create causal quantitative models of the organization's resources and processes. These models are first used to validate the strategic plan and the possible scenarios in developing the final strategic plan quantitatively and then later to provide insight into the execution of strategy in the face of economic reality.

There are two parts to investment modeling: a quantitative operational model and a monetized financial model. The operational (investment) model quantifies the resources required to support the revenue model's volume and mix of business, matches those against the organization's existing operational capacity, identifies areas where existing resources are unable to meet the revenue model's demands, and evaluates options for covering the resource shortfall. The financial model uses economic (not financial accounting) concepts to translate the operational model's quantitative data into measures of the economic realities of investment decisions.

THE OPERATIONAL INVESTMENT MODEL

The operational investment model is designed to ensure that operational constraints are not exceeded, that new investment capacity/capability will meet demand projections, and that the impact of a decision on an organization's investments, both tangible and intangible, are considered and measured.

Example: a manufacturer's revenue model has projected a sales volume and mix of business that will require 20,000 equipment hours to produce. The company currently has five machines available to provide those hours. Its operational investment model currently reflects its existing operating structure of working two, eight-hour shifts, five days per week. It also incorporates each machine's average downtime of 280 hours per year – 120 hours for maintenance and 160 hours for setups/changeovers. The model indicates that, under the company's current operating structure, the five machines are only available to provide 18,057 hours ([2,920 annual chronological hours per shift less 834 weekend hours less 280 downtime hours] x 2 shifts x 5 machines) of the 20,000 equipment hours required. To meet the requirements of the revenue model, the company's investments must be increased, employed differently, or supplemented.

The options for providing the additional 1,943 hours can be simulated and the quantitative results measured using the operational model. For example, working every other weekend provides an additional 416 annual hours per machine or another 2,080 per year. Adding another machine adds another possible 3,611 machine hours per year. Working two, nine-hours shifts, five days each week would add 2,607 available machine hours per year. Once the operational model establishes viable options for addressing the shortfall, those options can be monetized by the company's cost model and the results considered by the company's decision makers.

The operational investment model should not be limited to tangible investments. It must also consider whether the existing marketing, technical, employee skill, research, community relations and other intangible resources are sufficient for supporting the volume and mix of business projected by the revenue model. Any gaps should be identified, alternative actions to fill those gaps identified, those alternatives monetized by the company's cost model, and the results considered by the company's decision makers.

INTANGIBLE EXAMPLE

An initiative is undertaken to increase sales to existing customers by having product design engineers accompany salespeople to targeted customers over the next 12 months to identify new opportunities through education and observation. As you look at the availability of experienced design engineers, you need to consider:

1. Do they have the time to meet with the volume of customers you have targeted?
2. How many follow up meetings may be required?
3. What is the impact on regularly scheduled work and schedules of the Design Engineering Department?
4. Will additional design engineers need to be hired to accomplish routine work?

The investment in this initiative will be the time and corresponding salary and expenses of the experienced design engineers spend traveling, meeting, researching, and following up on customer opportunities. In preparing for this initiative, the company should decide if it is a substitute for existing work or additional work on top of that already planned and scheduled. If it is the later, the appropriate resources should be hired to support the new investment.

OPERATIONAL MODELING

Operational modeling for an investment project involves the following steps:

1. **Identify the gaps between current capability and needed capability.** The need for changes to organizational capability should be identified in the strategic planning process when the market and operational strategies are established, and the gaps between existing capability and the capability needed for the new strategies and objectives are identified.

2. **Define the options for new investments and general requirements.** This starts with determining the resources and capabilities that are needed to conduct the operations – marketing/sales, service/product generating, logistics/distribution, IT, analytic, etc. The options to create the necessary results must be explored for their operating capability and characteristics to determine if they will provide the organization the means to achieve the new strategic goals. This initial investigation is primarily operational and to some extend behavioral and cultural. The goal is to identify options.

3. **Compare the options.** The exploration of options ends when a set of reasonable solutions is established. At this point, the options need to be compared. Operational characteristics should be carefully evaluated for each option. Additional considerations involve risk management considerations, such as:

- Can the project be phased?
- Will each phase make standalone contribution?
- Do alternative uses exist for the investment if the market changes?
- What is the impact of project failure? How will failure be determined?
- Can the project be expanded if met with overwhelming success?

4. **Adapt the organizational operational model to evaluate organization-wide impacts, incorporating the various options.** This will help ensure the outcome is as expected, explore any constraints caused by the new resources or capabilities, and enable incorporation of changes into the project plan and cost estimate for final evaluation.

"Ensuring that operational modeling links to the strategic initiatives is critical to better profitability analytics. And creating the right operational model becomes even more important."

Cynthia Moehlman
Digital Profitability Director



THE MONETARY/FINANCIAL INVESTMENT MODEL

The financial impact of decisions being evaluated using the operational investment model are measured by entering the operational impact of those decisions into the causality-based cost and operating model. As a forward-looking, predictive model, the cost and operating model can take proposed investment actions and project their impact on the organization's resources and, in turn, monetize that impact to arrive at the economic consequences. In the case of the manufacturer mentioned earlier, the data populating the organization's cost and operating model can be adjusted for each of the three options and the economic results considered in deciding which option to select.

FUNDAMENTAL INVESTMENT MODELING PRINCIPLES

Only those expenditures required to preserve investments being consumed by current operations are to be assigned to products currently being produced or services currently being provided. Investments - both tangible and intangible - required to compensate for the failure to adequately invest in the past have nothing to do with current operations; they represent an overstatement of profitability in earlier financial periods. Similarly, neither tangible nor intangible investments made to grow the business relate to current operations. They are being made to support future operations. Therefore, neither category of investment represents a cost of current operations. They are funded by the profits from current products and services but are not a cost of producing or providing them.

Sunk costs are irrelevant. A sunk cost is a cost that has already been incurred and cannot be recovered. Sunk costs differ from prospective costs, which are future costs that may be avoided if action is taken. Sunk costs are irrelevant to decisions related to the future.

At any point in time, an investment should be measured by its value, not its original cost. The measure of an investment is the amount an investor does not have available to invest elsewhere because it is tied up in that investment. Its original cost is irrelevant. If you make a $10 thousand investment that has appreciated in value to $20 thousand, you no longer have only a $10 thousand investment. You have $20 thousand that is unavailable for investment elsewhere. The relevant value for decision making purposes is $20 thousand.

Owner's investment in a business is not "free money." Even though it does not appear in traditional financial statements, investor's opportunity cost is a legitimate business expense and should be incorporated into the cost information used by an organization's management in supporting internal decision making.

FOCUS ON MONETARY MODELING

The emphasis of monetary modeling is on economic reality and long-term profitability versus profit as defined by accounting standards, particularly for the short-term. Monetary modeling should reflect the causal operational model. When modeling projects for comparative evaluation, the cash flows associated with each option are critical to evaluating profitability and affordability.

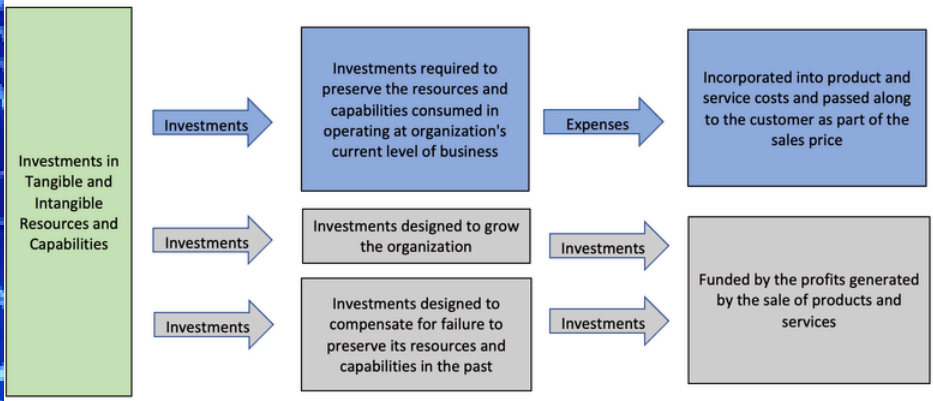
It is generally recognized that Net Present Value analysis of the cash flows associated with each project is the best way to compare different investment options. Yet while monetary performance is an important evaluation criterion, operating considerations can be even more important.

Another important consideration is investment financing. An individual company's ability to secure financing, its cost of capital for debt or equity financing, and current cash flows from operations can all be significant factors. Sometimes special financing is available from a prime contractor for a project which would also factor into the investment decision.

Once an individual project is monetarily modeled, it is important to adapt existing organizational models to incorporate the new resources and capability from the investment to assess its impact on overall organizational performance in future planning scenarios.

SEGREGATION OF INVESTMENTS

Future investment spending should be segregated into three categories, as shown below.



Only those investments required to preserve the resources consumed in operating the organization at its current level of business should be treated as expenses and incorporated into the measurement of product and service cost.

Investments made to compensate for those deferred in the past are not attributable to the organization's current business and should not be included in product or service cost. Similarly, investments made to support the future growth of the organization should be excluded from product or service cost. Neither of these investment categories are attributable to producing current products or services. They are funded by the profits generated by those products and services, not by assigning them to the products and services themselves.

When investments to grow the organization or compensate for failure to preserve the current level of operations are placed in operation, the cost of preserving them should be incorporated into product or service cost and, when possible given market factors, the sales price.

STRATEGY EXECUTION

Once strategic plans are made and the supporting operational and monetary models are built, the real work of management begins – executing the strategy to achieve the desired results. For investments, both tangible and intangible, this means managing projects and resources to achieve and implement the desired capabilities on time and on budget. It may also mean adapting the original project plan based on actual results and feedback being experienced in the organization's market and the broader economy.

The Strategy Execution phase of investment management must balance the original strategic plans and goals with the reality of market response – magnitude of success, magnitude of failure, and new opportunity/insights. The causal operational and financial models used for Strategy Validation can be used to test and examine decisions to make changes to investment plans during Strategy Execution. Scenario, revenue, cost, and resource assumptions in the models may need to be adjusted. Risk management plans developed during Strategy Formulation should also be reviewed for insight if it appears substantial changes to investments must be made during Strategy Execution.

Decisions in the execution phase, to the extent possible, should seek to apply the same long-term thought processes used during strategic planning to avoid short-term thinking and become trapped in an unwarranted or extended crisis management mode. High quality causal operational and financial models should be designed to allow scenario planning with a variety of resources, costs, and demand scenarios to support adaptive decision making quickly and accurately.

"Huron's Business Synchrony approach to strategic profitability focuses on harmonizing all relevant process, people, and data sources, driving meaningful and impactful execution with our clients."

Mike Gluhanich
Business Advisory
Managing Director



PERFORMANCE EVALUATION

Strategy Evaluation is essential to organizational learning, improvement, adaptation, and innovation. Investments must be evaluated from several perspectives:

- **Contribution to meeting strategic goals** – Did the investment contribute as expected to meet strategic goals? Was the investment too small, too large, or just right?
- **Return on Investment** – Did the investment achieve the anticipated return or results?
- **Project Management Performance** – Did the project meet its time, budget, and performance goals?
- **Risk Management Planning** – Did the investment encounter risks or changes? Did risk management plans support rapid and effective adaptation?

The goal of this evaluation is primarily to learn and improve strategic planning capability. Accountability may be necessary in some circumstances, but organizations that learn from their efforts, both successful and unsuccessful, are more likely to achieve long term success. The goal is to develop new inputs and adjust future strategic plans to achieve greater success.

Performance measurement should be multi-dimensional, meaning it should look beyond monetary measures. The high-level performance metrics and expectations should be established during strategic planning and refined and detailed during project planning. A clear record of the performance expectations, monetary and non-monetary should be maintained for use in evaluating an investment's performance. Non-monetary performance measures may include:

- **Impact on operations** – efficiency, quality, timeliness, continuous improvement, etc.
- **Impact on brand and reputation** – changes in customer perception of the company, public recognition, etc.
- **Impact on workforce** – employee satisfaction, safety, engagement, innovation etc.
- **Impact on customers** – customer acceptance/understanding, satisfaction, feedback/engagement, new opportunities, new customers, etc.
- **Impact on society and community** – community reaction, contributions to society/community, etc.
- **Impact on the environment** – fewer emissions, use of recycled materials, etc.

Depending on the size of the investment, it may be important to maintain monetary goals in both financial reporting terms and internal decision support terms. Over the long term, these measurements should be similar, but the differences between financial reporting measures and causality-based internal decision support measures may create significant difference in the short and intermediate terms. For projects with clear cash flow impact, the net present value analysis can serve as a good monetary baseline measure of the investment's performance.

THE ROLE OF DATA AND ANALYTICS

A robust external and internal data and analytics capability is essential to support an effective and robust investment program in internal capabilities. External data on the economy, customers, demand, competitors, technology directions, etc. help to identify the capabilities the organization needs to develop to achieve its strategic goals and maintain or enhance its competitive position. Internal data and analytics, such as causal operational and monetary models, are critical to:

- Evaluate project/investment performance
- Support organizational continuous learning from successes and failures
- Make effective and efficient decisions during project execution
- Project the project's impact on costs, revenues, and profitability as scenarios change
- Establish new baselines of performance for the organization
- Improve organizational confidence in internal investment and project capability
- Identify and prioritize investment opportunities throughout the organization.

THERE'S MORE!

In this eBook we've discussed PACE PAF and its strategic approach to investment management, which differs from the approach followed by companies basing their decisions on external financial reporting data.

There are additional considerations, not covered here, that must be considered when evaluating investments, including the pitfalls of using depreciation when evaluating investments, that we will discuss in our next eBook on investment management.

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