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Capital Budgeting and Strategic Planning: A Literature Review

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Abstract

Two areas of cost management that are critical to the success of an organization's strategic allocation of financial resources are strategic planning and capital budgeting. Most businesses engage in strategic planning and capital budgeting, however, some of the projects that they embark on are not efficiently managed and result in a lack of completion or an overrun of cost. What factors contribute to capital projects overrun or incompletion, and how can these factors be avoided? The purpose of this literature review is to discuss strategic planning and capital budgeting in relation to how managers achieve the organization's goal of strategic allocation of financial resources. The study will also identify factors that contribute to incomplete or overrun capital projects and look at possible ways to avoid the pitfalls. If capital projects are skillfully crafted through strategic planning, projects overruns will be minimized, if not eliminated.

Key words: Strategic Planning, Capital Budgeting, Capital Projects, Strategic Allocation of Financial Resources

1. Introduction

Strategic allocation of a business organization's financial resources can be done through cost management. Blocher, Stout, Juras, & Smith (2019) point out that "cost management focuses not on the measurement per se but on the identification of measures that are critical to the organizations' success" (p. 11). Two areas of cost management that are critical to the success of an organization's strategic allocation of financial resources are strategic planning and capital budgeting. Strategically managing financial resources is an objective that business managers aspire to achieve. Most businesses engage in strategic planning and capital budgeting, however, some of the projects that they embark on are not efficiently managed and result in a lack of completion or an overrun of cost. What factors contribute to capital projects overrun or incompletion, and how can these factors be avoided? What constitutes the strategic allocation of financial resources? Henry Mintzberg (2009) notes that "the world of strategy is messy and mixed up" (p. 162).

2. Purpose Statement

Strategy, according to the *Cambridge English Dictionary*, is the way in which businesses plan their actions over a period of time to improve their position and achieve their goals. Research about strategy has been ongoing and is now more prevalent. Included in the strategy research topics are strategy-as-practice, strategic management and strategic planning – among others. The purpose of this literature review is to discuss strategic planning and capital budgeting in relation to how managers achieve the organization's goal of strategic allocation of financial resources. The study will also identify factors that contribute to incomplete or overrun capital projects and look at possible ways to avoid the pitfalls. Egels-Zanden & Rosen write that "strategy is seen as something practitioners do as opposed to something that an organization has" (para. 3).

3. Literature Review

3.1 Strategic Planning

Strategic planning is encapsulated in the research of strategy or strategizing. Researchers seek to demonstrate how the various concepts of strategy or strategizing are expressed in strategy-as-practice, strategic management, and strategic planning, and how they have helped business organizations to become efficient in allocation of financial resources and successful in maintaining profitable earnings.

3.1a Strategy as Practice. Strategy-as-practice is becoming a leading approach to the study of strategizing (Brown & Thompson 2013). Various areas of research in the strategy-as-practice have been conducted. Machado (2014) examines the theoretical focus to study strategy-as-practice and indicate that it is developed for local level in implicit mode where what is highlighted is the act of strategizing over the formulation of strategy. Mueller (2017) emphasis of developing strategy-as-practice looked at performance, noting that the approach highlights strategizing—how strategy is actually performed, and how strategy is 'done in the doings' by certain people in certain locations at certain points in time. More recently, Kearney, Harrington, & Keller (2019) identified that research about strategizing has been conducted primarily at the level for larger firms, and performed strategy-as-practice research to provide management with a framework for developing strategy that is unique to small firms.

3.1b Strategic management. The growth of strategic management has been substantial according to Boyd, Haynes, Hitt, Bergh, & Ketchen (2012). Its formal inception in the late 1970s has grown rapidly as an area of research (Durand, Grant, & Madsen, 2017). Publications on the subject has expanded, states Engert, Rauter, & Baumgartner (2016), but the fields explored in the strategic management research was mainly built on traditional strategic management research of strategy formulation and implementation, and on the success factors of strategic management. The process of strategic management, according to Cosenz & Noto (2016), centers on what must be performed before a strategy is formulated through assessing whether or not the success of an implemented strategy is successful (para. 3). Further relayed by Duran et al. (2017) is that the leading areas of research addressed strategy processes, and examined the relationships between context strategy and performance, drawing heavily upon industrial organization economics and the economies of scale, transaction costs, and agency theory concepts of microeconomic (para. 4).

3.1c Strategic Planning. In the 1980s and early 1990s, much of the research relating to strategic planning focused on finding empirical evidence to link strategic planning with the performance of the organization (Wolf & Floyd, 2017). Spee & Jarzabkowski (2011) suggest that strategic planning does not only result in the planning of activities, but it also helps to shape the planning activities that occur during the process of the strategic plan development (para. 6). Mintzberg (2009) states that "unfortunately, strategic planning never worked as planned – it has never been conducive to developing strategy" (p. 162); but Ali (2018) notes that the evidence regarding the relationship between strategic planning and organizational performance is mixed and that while some studies reveal significant benefits from planning, others have found no relationship or small negative effects (para. 1).

3.2 Capital Budgeting

The theory surrounding capital budgeting, as pointed out by Blocher et al. (2019), has been routed in the field of finance, but accounting simplifies the process by helping decision makers successfully implement the decision models developed in finance (p. 463). Mukherjee, Al Rahahleh, Lane & Dunn (2016) note that as early as the 1950s capital budgeting practices of industries other than healthcare have been examined, and that practitioners have learned how to efficiently make capital budgeting decisions, while academia has learned to alter relevant theories based on feedback form business leaders (para. 1). Capital budgeting, according to Horngren, Datar, Foster, Rajan & Ittner (2009) is a decision making and control tool used in the process of making long-run planning decisions for investment in projects (p. 734).

To effectuate capital budgeting, a capital budget is prepared. The capital budget is "a listing of approved investment projects as well as anticipated cash inflows and outflows associated with these projects for a given period" (Blocher et al. 2019). The capital budget is linked to the master budget of the business organization and utilizes several budgeting methods to assist with the analysis of financial information. The capital budgeting methods used for analysis of financial information include the net present value (NPV) model and the internal rate of return (IRR) model – elements of the discounted cash flow model; and the payback model and the accounting rate of return (AAR) model – elements of the non-discounted cash flow model (Horngren et al. 2009).

3.2a Discounted Cash Flow Methods. Bennouna, Meredith, & Marchant (2010) state that both the NVP and the IRR models are consistent with the goal of maximizing a firm's value and highlighted that with NPV model, the generated present value of future cash flows is compared with initial outflows, and a positive NPV outcome deems the investment project acceptable (para. 2.2). Horngren et al. (2009) also point out that the NPV model calculates the estimated monetary gain or loss from the project by discounting all projected future cash inflows and outflows back to the present point in time using the required rate of return, while the "IRR is the discount rate that makes NPV = $0" (pp. 736-737).

3.2b Non-Discounted Cash Flow Methods. The payback model is cited as one of the non-discounted cash flow methods used in capital budgeting decisions. Al-Ani (2015) notes that one of the most prevalent methods in evaluating the capital budgeting decisions is the payback period. (para. 3). Blocher et al. (2019) defined the payback period as "the length of time required for the cumulative after-tax cash inflows form an investment to recover the initial investment outlay" (p. 489). Al-Ani (2015) further pinpoints that the payback period does not give realistic results because the technique ignores cash flows and the time value of money; and that the acceptance or rejection of the capital budgeting decision is based only on the result of the payback period because managers and investors do not consider other strategic variables besides the payback period when they evaluate the capital budgeting decisions (para 4).

4. The Relationship between Strategic Planning & Capital Budgeting

Having a plan of action is beneficial to business organizations because it serves as a guide and helps to facilitate the execution of the organizations' goals and objectives. What is debatable is the effectiveness of strategy when it is inserted into the plan. This difference of opinion is clearly seen among researchers who argue that strategic planning is and is not beneficial to an organization. The question posed is – if strategy is not incorporated into the planning stage, how will capital budgeting or the allocation of financial resources be meted out efficiently?

Strategy, according to Ali (2017), embodies a focus on the long-term direction of the organization, aligning the activities of the business to the environment to maximize opportunities and minimize threats, along with pairing the organization's activities to its available resources (para. 2). This emphasizes the need for organizations to strategically plan and budget accordingly for the allocation of financial resources. Implementing strategy into the plan will help the organization to carefully allocate resources while avoiding misuse or misappropriation of funds. Maritan & Lee (2017) highlight the complexity of resource allocation and note that resource allocation involves multiple activities conducted by management across functions, levels, and units, and that it is affected by social, political and economic factors (para. 1). Given the level of complexity, strategic planning should be included in the capital budgeting process to ensure satisfactory allocation of financial resources. Mathur (2017) indicates that a capital improvement plan mixes the general plan or master plan with financial planning, providing ways for setting priorities based on service levels, physical condition of assets, and available resources (para 2).

5. Contributing Factors to Project Overruns & Incomplete Projects

Excluding strategic planning from the capital budgeting process and not strategically applying the capital budgeting methods for analyzing financial resources can result capital project overruns and incomplete projects. Capital projects are often embarked on for investment purposes and for generating further revenue for the business. If not strategically planned and managed, these projects can result in an overrun of cost or they can remain incomplete for long periods of time and result in dilapidated conditions. Incomplete projects or project overruns can occur in different industries across the globe, in both private and public sectors. Several factors can cause projects to remain undone or be in an overrun status. Alleyne, Armstrong, & Chandler (2018) identify several overrun and incomplete projects on the island of Barbados, pointing out that the contributing factors to the project overruns were a lack of planning activities, inadequate risk management, and an undefine scope of cost management, among others.

Additionally, Garemo, Matzinger, & Palter (n.d), in an article "*Megaprojects: The good, the bad, and the better*" pinpoint over-optimism and over-complexity, poor execution, weakness in organizational design, and capabilities as reasons for failure in the execution of capital projects. Garemo et al. (n.d.) further note that when things falter in capital projects, some of the underlying reasons for failure—poor justification and the need for the project, insufficient planning, an under-estimation of cost and an over-estimation of benefits—were there at the beginning. Locatelli, Mariani, Sainati, & Greco (2016) also identify corruption as a factor in projects mismanagement, citing bribery, extortion, embezzlement, fraud, and nepotism as some of the elements of corruption that prevent successful completion of capital- or mega-projects.

6. Ways to Avoid Incomplete Projects and Project Overruns

6.1 Apply Strategy to Planning

The pitfalls of incomplete capital projects and project overruns can be minimized or eliminated through various means. Strategic planning can be instituted through scrutiny and careful examination of past or similar types of projects. Management should thoroughly examine past projects for causes of success or failures, and this will help the business organization to apply strategy to future projects. As noted, planning is one of the keys to success and should therefore be strategically implemented. Before financial resources are allocated to capital projects, project managers should carefully examine, highlight and note the risk factors relating to the projects and strategize to find ways to avoid those risks. Furthermore, project managers should lay out the activities of the project in a detailed schedule, even though the activities may not flow as planned due to several constraints. The probable constraints should be identified and extended time should be factored in at the beginning of the planning stage.

6.2 Manage Costs Wisely

While it is understandable that actual cost can vary from projected or budgeted cost, cost should be strategically managed to avoid excessive overruns. When undertaking capital projects, unforeseen problems can arise. Nevertheless, these problems should not be ones that require extreme additional spending. If consideration is given to probable constraints in the planning stage of the project and cost was factored in to mitigate the constraints, the unforeseen problems could then be aligned with the constraints and would be somewhat accounted for, avoiding unwarranted spending. Oftentimes, the benefits of the projects are touted and cost is sometimes minimized in order to rally support for the project. That way of think should be avoided. Cost management should always be adequately applied when planning for allocation of financial resources.

6.3 Eliminate Corruption

Corruption of any kind is not helpful or beneficial to any business and should be consider an illegal act for anyone engaging therein. This illegal practice should be forbidden in countries all across the globe. To eliminate corruption, there must be proper oversight of all capital projects, which should be given consideration at the planning stage. The managers responsible for decision making should also be managed, and there should be a series of steps required to verify transactions and evaluate decisions. No one person should have the sole responsibility of making decisions regarding capital projects. Having a group of people signing off on events and allocation of financial resources will help to eradicate corruption.

Consultation among management should be required for decision making. While this would not remove corruption completely, it will help to minimize the act. If one of the decision makers knows that consent from all of the remaining decision makers is required to reach an agreement, that decision maker would not be in a position to accept bribes from anyone in exchange for a favorable guaranteed decision. Also, nepotism will be avoided because the decision maker would not be in a position of show favor to a relative or close friend. Consultation among management will also help to lessen the possibility of embezzlement if several signatures are required for cash disbursement and capital expenditures. No single manager will be in a position to use his office or authority to extort resources for personal financial gain. Consultation among managers will help to promote transparency and minimize corrupt practices.

7. Recommendations and Conclusion

As the discussion regarding strategic planning continues, decisions will continue to vary regarding its application. A business organization cannot blindly embark on a capital project only by preparing a capital budget and evaluating performance. Capital projects must be carefully coordinated and the activities relating to such projects should be strategically planned. Different strategies should be developed and applied to facilitate adequate allocation of financial resources. If capital projects are skillfully crafted through strategy or strategic planning, incomplete projects and projects overruns will be minimized, if not eliminated.

Risk factors should also be identified at the planning stage of the project and analyses should be performed to help alleviate the risk. Costs should also be adequately managed and should be strategically applied in the capital budgeting process. Careful consideration should be given to the methods used to evaluate capital budgeting decisions and they should be strategically applied. While one method can be preferred over another, decision-makers should consider applying all methods in an attempt to effectively allocate the financial resources of the company with regards to capital projects. Furthermore, the various types of costs should be factored into the decision-making process and cost analyses should be performed so that all strategic variables can be applied to aid the decision-making process.

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