



## Balancing act: Managing stakeholder groups in capital-allocation decisions

In the midst of the capital-allocation process, it's often a struggle for CFOs to find common ground between all of the projects competing for funding and the stakeholders with their conflicting objectives.

As part of their decision-making, CFOs typically look for a balance between directing funds into strategic and longer-term investments and making shorter-term bets to generate cash flow. Similarly, they also need to navigate their way through stakeholders' differing aims and goals. The route, however, is often dotted with trade-offs and compromises, as groups of stakeholders concentrate on strategy or mission or return. Still, in the end, these factions are expected to converge on an agreed-upon formula.

The task can be even more daunting than it sounds, considering the range of stakeholders. They include **project managers**, who bring new ideas and passions to their business case requests, but tend to exhibit optimism bias; the **finance team**, which is responsible for pulling together the analysis, while trying to minimize bias and provide insightful framing; members of the **executive committee** who, among others, want to lobby for their own business units to get maximum funding; the **board**, which conducts oversight and makes the final decisions on major projects; and finally, **investors**, who scrutinize capital-allocation decisions to ensure they conform with their expectations for return on capital. In addition, other external stakeholders,

such as customers, business partners, and regulators, factor into the decision-making indirectly and their perceptions and interests are not always aligned.

Of course, it's crucial that any plan, once filtered through several levels of stakeholders, does not emerge too diluted to serve its intended purposes: maximizing returns, while also fortifying company strategy and resiliency. In this issue of *CFO Insights*, we'll discuss how finance executives can leverage the views of different stakeholders to help sharpen their approach to allocating capital—and emerge from the exercise with not only a stronger balance sheet, but also a much-improved capital-allocation process.

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### An integrative effort

As with much of management decision-making these days, the margin of error that CFOs have in making capital allocation choices is narrow. In Deloitte's [North American CFO Signals™](#) survey for the second quarter of 2019, for example, more than two-thirds of respondents said they expect to pursue a growth strategy characterized by making fewer, if more concentrated, investments over the next three years (see Figure 1.) But while such carefully thought-out allocation strategies can propel a company to the fast lane, a wrong turn can undermine performance, incite activist investors, and even attract hostile acquirers.

With so much at stake, it's incumbent on CFOs to re-examine the environment in which they are allocating capital. That environment involves not only a roster of stakeholders, but also a complex assortment of data points, diverse approaches to analytics, and divergent goals. Moreover, beyond project selection, there are budgeting and governance decisions that need to be hashed out.

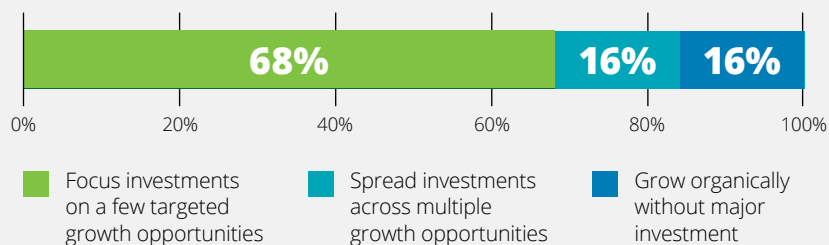
Still, given that capital allocation plays a big part in how companies create—and sustain—value, it behooves finance chiefs to improve the quality of the process. For starters, CFOs need to make sure they are collecting the relevant data, applying the appropriate analytical tools, and enhancing other efficiencies, reducing the opportunities for the process to get bogged down in debate.

In some cases, automated tools can help categorize potential investments, providing a common platform for evaluating them and supplying sufficient detail to fuel informed decision-making. In other cases, streamlining the process may be as simple as cutting in half the 10-point rating scale for potential projects, leaving less room for inconsistency. For instance, an international financial institution with a portfolio of hundreds of internal process and technology projects managed to reduce its business case criteria from more than 20 factors to fewer than 10; in the process, it improved the accuracy, insight, and timeliness of its analysis.

**Figure 1. Approaches to growth**

*Which best describes your preferred approach to growth over the next three years?*

Percent of CFOs selecting each option



Source: North American CFO Signals, Q2 2019, CFO Program, Deloitte LLP

### Setting ground rules

Beyond building a sound technological foundation, CFOs need to create a forum where stakeholders have room to express relevant views, without the process devolving into a free-for-all. Among the ground rules that need to be established to produce structured, logical, and fact-based decisions are the following:

- **Set clear and measurable objectives.**

It's crucial that capital-allocation decisions take place within an atmosphere that operates with agreed-upon processes and decision criteria. Such consistency is key to finding an acceptable balance between the need for continuing strategic investment and the requirement to keep generating capital. A common pitfall is not providing enough specificity for project managers on how objectives and criteria will be measured, and typically it falls on the finance team to lead a multi-stakeholder process to integrate all relevant factors.

- **Mandate a timeframe for completion.**

Capital is limited, and the time frame companies have to consider and prioritize their options should be, as well. Companies can progress along a maturity scale from ad-hoc to standard definitions to integrated processes to optimized processes to strategic agility. But completing the initial step of standardizing definitions, measures, and data is important to streamlining the process and improving agility. The finance team usually needs help from data scientists and IT to develop these standards; using an integrative stakeholder process with project managers can improve organizational buy-in and analytical completeness.

- **Design a process to assess decisions.**

Investments may be aligned with financial, strategic, and risk goals. CFOs need to design a structured process by which they can be reviewed and fairly compared (see [“Capital allocation: Seeing the value in value architecture,” CFO Insights, April 2018](#)). Perhaps there is a need for a more complete and specific business case template for comparing projects or for reporting dashboards that enable decision makers to ask what-if questions and monitor ongoing performance. A specific factor in building confidence is having a realistic understanding of human bias during the capital-allocation process and, where possible, building in practical steps to expose or minimize it. (For more on applying unbiased processes, see [“Capital allocation: Recognize bias in your decision-making,” CFO Insights, February 2018](#).)

- **Make sure stakeholder groups know their roles and responsibilities.**

Stakeholders ideally share an interest in making sure that capital is deployed with maximum efficiency. But they likely have their own definitions of what that means, even if they are attempting to be neutral. CFOs should bring clarity to those roles and responsibilities. Transparent governance and improved accountability in capital allocation are substantially enabled when a broad set of stakeholders are involved in developing standard objectives, measures, tools, and processes.

## Burning questions in capital allocation

As they strive to take a formal and systematic approach to allocating capital, CFOs will solicit feedback from stakeholders: Do they think a certain strategy will generate sufficient returns on capital? The answer, it's safe to speculate, will be yes—and no.

There will be stakeholders on both sides, and perhaps some in the middle. That's because the capital allocation process involves a crowded collection of interested parties, organized in groups that align with their own metrics, time horizons, and objectives.

Some hotly contested and polarizing questions that CFOs need to confront—even as conflicting sentiments pour in from stakeholders—may include:

1. **How much debt is too much?** What may look too conservative to long-term stakeholders can appear to others like it exposes the company to too much financial risk, despite its potential for generating ample returns. Paying down debt offers a predictable strategy, but returns may be anemic in a low-interest-rate economy.
2. **Is now the time to issue or increase dividends?** Short-term investors will likely love the idea, but management may have a strong case to make that issuing or increasing dividends conflicts with the company's long-term plan, which requires ongoing capital spending. It's a strategy perhaps best suited to businesses that don't anticipate copious capital demands.
3. **Would repurchasing shares enhance value?** Short-term shareholders may see stock buybacks as a straightforward path to boosting value, assuming the share price is relatively cheap. But investors with longer-term interests may view deploying capital this way with suspicion, worrying that the strategy is designed to prop up performance metrics, such as earnings per share.
4. **Will M&A create shareholder value?** The terms of such deals are typically analyzed on a case-by-case basis, leaving room for disagreement as to what constitutes a sensible price and whether to fund it using excess cash or debt. The results of the management team's due diligence, straightforwardly presented, ought to convey the financial reasoning for all stakeholders to consider.
5. **Does it pay off to reinvest in the business?** Having captured data as to the drivers of profitable growth, CFOs should be capable of evaluating whether reinvesting capital effectively, as opposed to tying it up in noncore business units, can increase value and fortify the business strategy. In an era characterized by uncertainty and disruption, the business—like the capital-allocation process itself—will likely benefit by strengthening its flexibility without weakening its performance.

As with directing capital toward the investments with the highest returns, addressing stakeholders' concerns requires careful consideration and wide-ranging discussion. The payoff of an ongoing dialogue should extend beyond making sure every group feels heard; ideally, internal stakeholders ought to emerge from the process with a fuller understanding of the organization's strategy and objectives. Fostering a more productive relationship between finance leadership and stakeholders, after all, is undoubtedly in the organization's best interests.

## Understanding your stakeholder groups

To communicate effectively around capital allocation, CFOs need to be able to persuasively articulate the rationale behind the decision-making. To speak convincingly, however, they must know their audience. That requires understanding how each stakeholder group adds value to the capital-allocation process, which in turn can influence their own priorities and preferences.

Typically, stakeholders will fall into one of the following groups:

- **Investors**, as the providers of capital, want to make sure that any given capital-allocation decision confirms their collective vision of the company's future. They look at capital through the lens of "opportunity cost": where else can they

get similar or better returns for similar or less risk? They may be less inclined toward strategic, risky, or long-term investments, and more inclined toward predictable and short-term deployment of capital. While they expect the board to represent their interests, they may have opinions as to what should be done with any extra cash on the balance sheet, especially since they are expecting both a return *on* their capital investment and ultimately a return *of* their capital investment.

- **The board**, as might be expected, provides oversight, making sure management sufficiently scrutinizes the options, and ensures that capital is deployed where it will likely achieve the highest return and that it is returned to shareholders based on expectations

and competitive benchmarks. Its role in capital allocation isn't to take sides regarding projects, but rather to thoughtfully consider the range of options. Its members will also hold management accountable for the results and will likely have plenty to say should a decision turn out badly—especially if they feel that problems have been minimized when reported to management. Such "greenwashing," as it's known, overlooks unwelcome facts and details for the sake of portraying the desired progress up the chain of command. Similarly, a large internal IT investment that doesn't deliver leaves in its wake a memorably large price tag, a lost opportunity to become more competitive—and a very restive board.

- **Executive committee members** are often a mix of corporate executives, including the CFO and business unit leaders. Their role includes setting the strategic vision and developing the key objectives for capital allocation. Through their efforts, and with help from the finance team, strategy, data scientists, and other functions, they are representing what they perceive to be the stakeholder interests of their external business ecosystem: they define how to approach the perceptions of key business partners, supply chain partners, customer segments, regulators, and the like. Their guiding questions: what objectives are these external stakeholders looking for from us, and how do we set the capital-allocation process to optimize those objectives?
- **The finance team** is responsible for assembling information and analysis, continually improving the processes and infrastructure to support senior executives, and—as organizations move beyond a static approach to capital allocation—helping improve the company’s strategic agility as economic conditions change. This team may also

assemble the data necessary to support a decision for which the CFO needs to make a business case. A large utility company with capacity constraints, for example, almost reflexively invested in adding incremental power-generation capacity. But it may be that an investment in strengthening distribution—by trimming trees—would be a tougher sell, yet a wiser investment. Calculating the return, though, may require having the finance team weave together divergent strands of data, and spend time poring over spreadsheets.

- **Project managers**, and other employees with capital-hungry ideas, have proposals that they will likely insist offer a better potential return than other options under consideration. These stakeholders should be heard and re-heard; if they keep championing potential projects, they may very well hit the target at some point.

As diverse as these stakeholder groups may be, CFOs should take an integrated approach to understanding each—making sure they each get a hearing during the capital-allocation process and carefully eliciting the actionable ideas they offer.

### **Accepting the challenge**

Ironically, there are probably few projects that could unite stakeholders—in shared skepticism—as efficiently as the decision to make changes in the capital-allocation process. For CFOs to pick up that mantle, they should have confidence that they can make practical improvements.

They should also be armed with a data-based case for taking on the project, deterring stakeholders from lining up against the idea. With input from others, CFOs can lead the way in coming up with defensible methods for scoring investments, monitoring risks, and developing dashboards.

By applying a higher level of structure to the capital-allocation process, CFOs can aim to deploy cash to pursue new opportunities or imbue their businesses with added resilience. In the face of ongoing uncertainty, it can only help to have a unified group of stakeholders who are poised to allocate capital opportunistically. Given the speed at which the marketplace changes, it won’t be long before CFOs will likely be enlisting stakeholders in the next effort to revamp the capital-allocation strategy.



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