EM-31.2

Category: **Board & Management Operations**
Topic: **Business Strategy & Planning**
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Overview

The *Business Strategy & Planning* topic provides guidance on evaluating a Farm Credit System (System) institution's business strategies and plans, including the planning process, internal controls, reporting, and compliance with related regulations. Business planning is an organized and continuous process of ensuring that projections of the future operating environment influence current decisions. In its simplest terms, planning is the process of determining where the institution is, where it would like to be, and how it plans to get there. Planning can be divided into two components: strategic and operational. Strategic planning focuses longer-term on defining an institution's strategy (or direction) and resource deployment to pursue that strategy, whereas operational planning concentrates on shorter-term or tactical actions to achieve the strategic direction.

The planning process requires the involvement and commitment of both the board and management. The resulting business plan should communicate the institution's mission statement, goals, and objectives, and establish how the institution will use its resources to accomplish them. The plan should also reflect sound lending principles and demonstrate a realistic assessment of risks in light of economic and competitive conditions in the market to be served.

The business plan provides a road map for achieving safe and sound operating results and fulfilling the institution's public mission as a government-sponsored enterprise (GSE) serving the needs of agriculture and rural America. Although Farm Credit Administration (FCA) Regulations require each System institution to annually adopt a business plan that includes certain items, there is no model plan. Likewise, an institution can be in compliance with regulations but still not have an effective plan. Business plans can, and should, differ in form and content based on factors such as complexity of operations, financial condition, operational issues, and organizational structure. Examiners should consider these factors when evaluating the adequacy of an institution's business planning process and products, keeping in mind that while regulatory compliance is important, it should not be the examiner's only focus.

Examination of the *Business Strategy & Planning* topic needs to be closely integrated with examination work in all topical areas. It's through examining these other areas that examiners are able to determine if the business plan is being effectively implemented and is achieving the desired results. When examiners identify concerns in other areas, they should determine whether an underlying cause can be traced back to weaknesses in the business plan or planning process.

Examination Procedures and Guidance

General

1. Policy & Process:

Evaluate the effectiveness of the institution's planning policy and process.

Guidance:

The quality of the business plan is dependent on the effectiveness of the planning process. An accurate assessment of current conditions, realistic assumptions, and attention to details when developing and implementing the plan increase the likelihood of achieving the desired business results. The planning process should be ongoing and integrated into an organization's operations. Frequently, deficiencies noted in the business plan are the result of flaws in the planning process. A board policy that outlines the parameters of the planning process serves as an important control to ensure effective planning.

Evaluative questions and items to consider when examining planning policies and processes include:

- ***Board Involvement:*** **Is the board sufficiently involved in planning?** The planning process should be outlined in a board policy and be endorsed by both the board and senior management. The policy should include the expectations and responsibilities for developing, approving, executing, and modifying the plan. It should also require regular board reporting that is sufficient to monitor achievement of the goals, strategies, and projections. If there is no policy, the process should be sufficiently documented by other means. Without leadership support and engaged participation, the planning process is reduced to a meaningless exercise and the plans may be unreliable indicators of future actions. Refer to *The Board's Role in Providing Business Planning and Strategic Direction* section in The Director's Role for additional guidance on board involvement in planning.

- ***Management Responsibilities:*** **Does the planning process include sufficient procedures and internal controls to ensure compliance with regulatory and board policy requirements?** Management should develop procedures or maintain other similar documentation that defines the activities and steps in the planning process. Management typically facilitates the planning process and is responsible for ensuring the board has the information it needs to make planning decisions. Oftentimes, institutions will also use external experts or planning facilitators to help ensure an independent and effective planning process. A third-party review by the compliance officer or internal audit is another effective internal control to provide the board with assurance that management has addressed key items and that regulatory requirements are met.

- ***Business Plan Adjustments:*** **Does the process address interim adjustments to the plan?** Expectations should be defined for how, when, and by whom needed adjustments will be evaluated, approved, and implemented.

- ***Models:*** **Are the models used for business planning managed in accordance with the institution's model risk management (MRM) framework and the guidance outlined in FCA's *Model Risk Management* procedure in the *Corporate Governance* Examination Manual topic?** These models should be included in the institution's model inventory, which should accurately represent each model's risk, materiality, and validation status. Model validation, change controls, staffing, separation of duties, and new model development should be consistent with the guidance in the institution's MRM framework and FCA's *Model Risk Management* procedure, recognizing that application of this guidance varies based on model risk and materiality. *Note: Examiners completing this procedure should focus on the specific model(s) being used; the overall MRM framework is examined using the Model Risk Management procedure referenced above.*

2. Projections:

Evaluate the adequacy of business plan projections, including underlying support and assumptions.

Guidance:

Financial projections are an integral and required part of an institution's business plan. FCA Regulation 618.8440(b) requires pro forma financial statements for each year of the plan, as well as a detailed operating budget for the first year of the plan. The plan's projections should identify realistic financial results that are consistent with the board's risk appetite, the institution's risk-bearing capacity, and the current and projected economic environment.

Before evaluating projections, it is important to understand the key assumptions underlying the projections, including challenges and opportunities within the institution's current operating environment. Key assumptions could include items such as expected loan growth, credit quality, allowance provisions, nonaccrual loans, interest rate levels and spreads, patronage income, operating expenses, capital expenditures, human capital needs, liquid funds availability, capitalization level, and patronage distributions. The plan should identify assumptions used in preparing the business plan projections and financial statements.

Evaluative questions and items to consider when examining business plan projections include:

- ***Financial Condition and Performance:* Do the projections indicate the institution will maintain or achieve satisfactory financial condition and performance in the current plan year and the remainder of the planning horizon?** If projections evidence any material changes in financial condition and performance from year to year or between historical and projected results, the plan should address the underlying causes. For projections that indicate less than satisfactory financial condition or performance, the plan should identify specific strategies for improvement. In addition, examiners should consider the prior year's planned versus actual results to evaluate past success in achieving projections. FCA's *Business Plan Projections* workpaper (see Part 3 of the Examination Manual) provides examiners a tool to analyze business plan projections and compare them to prior years.

- ***Risks:* Does the plan sufficiently address risks that may affect the ability to achieve current year projections (e.g., credit risk, interest rate risk, operational risks, etc.)?** An understanding of the risks likely to impact operations provides a sound basis for determining whether the projections are achievable. The plan should discuss these risks within the internal and external analysis required by FCA Regulation 618.8440(b)(2). Additionally, FCA Regulation 628.10(e)(2) requires the institution to assess its overall capital adequacy in relation to its risk profile as part of developing the capital adequacy plan. This would include consideration of the factors identified in FCA Regulations 615.5200(a) and (c), as well.

- ***Assumptions:*** **How reasonable are the assumptions underlying the projections?** Assumptions should be reasonable when compared to historical results and planned or projected changes in the operating environment, as discussed above. For fast growing institutions or those projecting significant growth, the FCA Informational Memorandum on Asset Growth, Market Volatility, and Best Practices for Fast Growing Institutions dated May 9, 2008, identifies several best practices related to business plan assumptions and projections. Institutions should also consider various possible scenarios when establishing their baseline assumptions and projections. Considering these alternative scenarios together with stress testing should be a routine part of any institution's business planning process, as discussed in the Informational Memorandum on FCA's Stress Testing Expectations for All FCS Institutions dated March 4, 2010.

- ***Loan Portfolio Planning:*** **Are the board's loan portfolio expectations and risk appetite consistent with the institution's risk management capabilities, internal control systems, income-generating capacity, risk-bearing capacity, and existing and prospective risk conditions?** Refer to the *Planning & Strategies* procedure in the *Portfolio Planning & Analysis* Examination Manual topic for additional guidance on loan portfolio planning.

- ***IT Needs:*** **Are information technology (IT) needs and plans sufficiently addressed?** Major investments in IT have long-term implications on both the delivery and performance of automated products and services. Therefore, IT needs should be integrated into the overall business planning process. While the extensiveness of technology plans will depend on the nature and complexity of operations, each institution should consider the following areas when preparing business plan assumptions and projections: hardware, software (commercial and in-house development), personnel, and budgets.

3. Objectives, Strategies, & Action Plans:

Evaluate the objectives, strategies, and action plans to determine their adequacy in guiding the institution and addressing key risks and threats.

Guidance:

An effective business plan should clearly identify objectives, strategies, and actions to accomplish the institution's mission statement and goals. Collectively, these plan components represent the approach to achieving the board and management's vision and attaining the financial and performance projections. When establishing these elements of the plan, the board and management should consider the risk environment, the board's risk appetite, the institution's risk-bearing capacity, and the institution's various business initiatives, including any planned new initiatives.

Evaluative questions and items to consider when examining business plan objectives, strategies, and action plans include:

- ***Road Map for Operations:*** **Is the plan effective in establishing the board and management's road map for achieving safe and sound operations and fulfilling its public mission as a GSE?** Institution planning should consider all significant areas of operations (e.g., credit, finance, and operations, including information technology). The objectives, strategies, and actions should consider that the various operational areas are interrelated; thus, planning for one area often overlaps planning for other areas. Regarding public mission, an important component of an effective plan is addressing how the institution will ensure it is providing products and services to all creditworthy and eligible customers.

- ***Establishing Objectives, Strategies, and Actions:* Has the institution developed appropriate short- and long-term objectives, strategies, and actions for key aspects of operations? Are they logical, achievable, consistent with the risk environment, and within the institution's risk-bearing capacity?** Depending on the institution, the objectives, strategies, and actions should address issues such as capital needs, loan growth, market share, loan portfolio quality, information technology, human resources, and loan pricing. Additionally, the plan should address staffing or resource needs relating to the risk environment, new business initiatives, or projected retirements and other attrition.

    - To develop the most effective objectives, strategies, and actions, management should assess the institution's present financial position and operating environment, along with the capabilities and depth of management and staff. A situational analysis of internal and external factors, as required by FCA Regulation 618.8440(b)(2), is an important part of developing logical and well defined assumptions. Likewise, the assessment of capital adequacy needs in relation to the institution's risk profile is important for identifying a comprehensive strategy for maintaining an appropriate level of capital, as required by FCA Regulation 628.10(e)(2).

    - The institution should thoroughly evaluate any significant new business initiatives and address them in the planning process. These evaluations should consider factors such as advantages, disadvantages, downside risk, impact on business plan projections, resources and skills required, and control processes needed. The details of these evaluations do not need to be in the business plan, but should be available to the board when it considers and approves the initiative.

    - Boards should consider the potential departure or retirement of a chief executive officer or other key officers in strategic and succession planning.

- ***Stress Testing Results and Alternative Scenarios:* If stress testing results reveal potential concerns, do the plan's objectives, strategies, and actions address them?** The Informational Memorandum on FCA's Stress Testing Expectations for All FCS Institutions dated March 4, 2010, details how stress testing is an integral part of business planning. It states that when done effectively, stress testing provides the board and management valuable information for use in key decisions. An effective process includes identifying risks, evaluating those risks, and developing alternative projections and strategies as a way of preparing for unexpected events that could adversely impact results. While not required by regulation, a sound practice is to identify alternative scenarios and strategies to mitigate the effect of undesirable events on financial condition and share these with the board. Refer to the *Reporting Results* and *Using Results* procedures in the *Portfolio Planning & Analysis* Examination Manual topic for additional guidance.

- ***Correcting Identified Weaknesses:* If needed, does the plan include strategies for correcting identified weaknesses in the board, management, or workforce as required in FCA Regulation 618.8440(b)(2)(iii)?**

4. Regulatory Compliance:

Evaluate compliance with regulations related to business and capital planning.

Guidance:

FCA Regulations identify specific requirements for business plan development, content, and approval. While compliance with regulations does not ensure the development of a sound and effective business plan, the regulations help to establish a baseline of standard expectations. General expectations are summarized below (refer to the regulations for details).

- FCA Regulation 618.8440 requires the board to adopt an operational and strategic business plan for at least the succeeding 3 years. The plan must be adopted no later than 30 days after the commencement of each calendar year and include, at a minimum, the items specifically outlined in this regulation.

- FCA Regulation 615.5200 requires the board to establish, adopt, and maintain a formal written capital adequacy plan as a part of the business plan. The plan must include the capital targets that are necessary to achieve the institution's capital adequacy goals and address other specific items required in the regulation.

- FCA Regulation 614.4165 requires business plans for direct lender associations to include annual quantitative targets and qualitative goals for the institution's young, beginning, and small farmers and ranchers programs. These targets and goals must be identified for at least the succeeding 3 years of the plan. In addition, the quantitative targets must be based on an understanding of reasonably reliable demographic data for the lending territory.

- FCA Regulation 609.935 requires institutions that engage in E-commerce to include in the business plan a description of the E-commerce initiatives, including intended objectives, business risks, security issues, relevant markets, and legal compliance. To further clarify the expectations of this regulation, FCA issued an Informational Memorandum on Compliance with Farm Credit Administration E-commerce Regulations in Business Plans dated November 25, 2004.

Refer to FCA's *Business Planning Regulatory Compliance* workpaper for additional guidance and information (see Part 3 of the Examination Manual).

5. Reporting:

Determine if reporting on the achievement of business plan objectives, strategies, and projections is sufficient.

Guidance:

Institutions should periodically analyze and report business plan activities as part of monitoring, directing, and controlling operations. Analysis and reporting provide the board with information needed to ensure progress toward achieving business plan projections and objectives. Without timely and reliable analysis and reporting, variances might go undetected and exceed board-established parameters, to the point where the institution's condition is materially affected. More commonly, unreliable reports cause the board and management to miss opportunities to adjust business operations in a timely manner and fail to maintain safe and sound operations or fulfill its mission.

The Director's Role indicates the board should establish reporting requirements for each component of the plan and review the institution's performance at least quarterly to evaluate the appropriateness of both the strategic and operational components. During the review, directors should consider new opportunities, changes in the operating environment, and external developments to decide whether adjustments to the strategic direction are needed.

Evaluative questions and items to consider when examining business plan reporting include:

- ***Planned Versus Actual Performance:* Does management evaluate and report to the board on planned versus actual results for all key financial projections in the plan, including updates on potential operational or financial problems?** Reports should identify the underlying causes of material variances and address any adjustments needed to the projections. In addition, reporting on other variances (e.g., current year-to-date compared with last year-to-date, and current month compared with prior month) can provide the board insight into changes in performance and potential risk areas.

- ***Accomplishment of Plans:* Does the board receive sufficient progress reports on accomplishment of planned objectives, strategies, and actions?** The reporting should be sufficient to inform the board of any significant problems, delays, or adjustments needed in implementing operational objectives, strategies, and action plans. New initiatives may require more specialized or frequent reporting than what is needed for ongoing business initiatives. Report content and frequency should be consistent with board policy or process requirements. In addition, annual reporting on progress in accomplishing human capital and marketing plan strategies and actions must comply with requirements in FCA Regulation 618.8440(c).

- ***Interim Changes to Plans:* Has management made appropriate interim changes to financial projections or business plan strategies based on year-to-date results or unexpected events?** Similar to initial plan projections, the board should review and approve such changes.

- ***Adequacy of Information Systems:* Do information systems contain sufficient data and information to support analysis and reporting on accomplishment of business plan projections, objectives, strategies, and action plans?**

6. Audit:

Determine if the institution conducts an effective audit (scope, reporting, and followup) of business planning.

Guidance:

The internal audit and review program is a key mechanism for ensuring business planning processes are functioning effectively and in compliance with regulations and policies. The internal auditor or other qualified, independent party should review the adequacy of business planning to ensure compliance with applicable criteria. The audit risk assessment and scope should address business planning topics, and audit or review frequency should be commensurate with the complexity of the institution's operations and risk profile. A review by internal audit is also important for providing the board reasonable assurance that ongoing analysis of and reporting on business plan results are complete and accurate. The potential impact of unreliable reporting supports the need for strong detective controls in the form of audit coverage.

Note: This procedure focuses on evaluating the reliability and effectiveness of internal audits and reviews in this topical area. Refer to the *Audit & Review Programs* topic in the Examination Manual for guidance on examining the overall internal audit and review program.

Evaluative questions and items to consider when examining the audit or review of business planning include:

- ***Audit Coverage:*** **Is there periodic audit or review coverage of business planning and reporting?** Audit or review coverage and frequency should be appropriate relative to risks, changes in the operating environment, regulatory requirements, and periodic testing needs. Coverage should also be consistent with the institution's risk assessment results and annual audit plan.

- ***Scope and Depth:*** **Are audit or review scope and depth sufficient to conclude on the adequacy, completeness, and timeliness of business planning processes and reporting?** The scope and depth of work, including transaction testing, should cover the primary processes and controls within the area being audited or reviewed and be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of coverage should be documented and consistent with the approved audit or review plan and engagement contract (if applicable). Audit or review workpapers should be examined to verify the actual scope and depth of work performed. The workpapers may indicate the scope and depth deviated from what was identified (or implied) in the audit plan. For example, workpapers may indicate the work performed was limited to evaluating the existence of policies and procedures and didn't include reviewing other controls, such as training or reporting, or testing compliance with regulations or institution guidance. If the work deviated materially from the original planned scope, internal audit should notify the board (or Audit Committee, if so delegated) of the reasons for the change. Specific items that should be considered in the audit or review scope include:

    - Business planning policies and procedures.

    - Compliance with business planning policies, procedures, FCA Regulations, and other FCA guidance.

    - Monitoring and control processes (e.g., reporting, management oversight, management information systems).

    - Business plan documents, including the projections, objectives, and strategies.

    - Management of all significant business planning models, including consistency with the institution's overall model risk management framework.

    - Fraud-related threats and vulnerabilities, as well as anti-fraud controls.

- ***Reliability of Results:*** **Did FCA identify any concerns with audit or review reliability?** It is important to understand the scope and depth of the audit or review being examined, as discussed above, when evaluating audit or review reliability. With this understanding, the following are key considerations when evaluating the reliability of audit or review results:

- *FCA Testing* – Evaluate the reliability of internal audit or review work by comparing the results to FCA's examination results in this area. This comparison often includes FCA testing transactions that were covered in the internal audit or review (transactions are often loans or loan applications, but may include other types of transactional activity, as well). In addition to the audit or review report, examiners should request and review the workpapers and hold discussions with the auditor to obtain a more thorough understanding of work completed. This can be especially important if the audit or review report is not sufficiently detailed or FCA's examination work and testing identifies potential concerns. Auditors and reviewers complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant audit evidence when conducting and supporting their work. (IIA Standards 2240, 2300, 2310, and 2320) Workpapers should adequately document the work performed and support the final report. If FCA identifies weaknesses that were not identified in the audit or review, the cause for any discrepancy should be determined.

- *Audit/Review Staffing* – Whether internal or outsourced, auditors and reviewers conducting the work need to be qualified, independent, and objective to ensure reliable results. They should have the right mix of knowledge, skills, and other competencies needed to perform the work. (IIA Standard 2230) Additionally, auditors and reviewers need to be independent of the activities they audit so they can carry out their work freely and objectively. (IIA Standards 1100, 1112, 1120, and 1130) For example, audit and review staff should not be involved in developing and installing procedures, preparing records, operating a system of internal controls, or engaging in any other activity that they would normally review. Examiners should evaluate the staffing on the individual audit or review being examined as part of determining the reliability of results.

- *Institution Review of Work Performed* – The institution should complete an independent review of the workpapers to ensure audit or review objectives and scope were met and the results and conclusions were reliable and supported. (IIA Standard 2340) Examples could include a supervisory review of in-house audit work by the CAE or other audit staff, or a review of outsourced work by the CAE or audit coordinator. Examiners should consider whether the institution completed these reviews, and if any concerns were identified, when concluding on audit or review reliability.

- ***Reports:* Does the internal audit or review report sufficiently communicate business planning and reporting review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report:

  - Is the report prepared and communicated in accordance with the institution's guidelines?

  - Is an executive summary or overview included to provide the board with a general conclusion on audit or review results?

  - Is the report accurate, concise, supported, and timely in communicating the audit or review objectives, scope, results, conclusions, and recommendations? (IIA Standards 2330, 2400, 2410, 2420, 2440, and 2450)

- Are conclusions and recommendations realistic and reasonable, with material and higher risk issues clearly identified and prioritized?
- Are conclusions and recommendations supported by convincing evidence and persuasive arguments (condition, criteria, cause, and effect)?
- Do results in the workpapers align with report conclusions?
- Does the report conclude whether the institution adheres to policies, procedures, and applicable laws or regulations, and whether operating processes and internal controls are effective?
- Does the report address potential vulnerabilities to fraud, if applicable?

- ***Corrective Action:*** **Are management responses to audit or review findings in this area reasonable, complete, and timely? Have corrective actions been effective?** Audits and reviews are only effective if corrective action is taken to remedy the weaknesses identified. As such, there should be a reasonable, complete, and timely management response to the audit or review report. Management commitments and agreements or any areas of disagreement should be documented in the report or in a separate memo or tracking system. (IIA Standards 2500 and 2600) If corrective actions are not resolving the issues or concerns in a timely manner, examiners should further investigate the reasons. For example, this could indicate the audit or review did not sufficiently identify the underlying causes or materiality of weaknesses, sufficient resources are not being directed toward corrective actions, or weaknesses exist in the institution's corrective action process, including board oversight of the process.