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Financial Policy and Corporate Strategy

BASIC CONCEPTS

1. Strategic Management Decision Making Frame Work

Strategic management is a systems approach, which is concerned with where the organization wants to reach and how the organization proposes to reach that position. It intends to run an organization in a systematised fashion by developing a series of plans and policies known as strategic plans, functional policies, structural plans and operational plans.

2. Strategy at Different Levels

Strategies at different levels are the outcomes of different planning needs.

- **Corporate Strategy**: At the corporate level planners decide about the objective or objectives of the firm along with their priorities. A corporate strategy provides with a framework for attaining the corporate objectives under values and resource constraints, and internal and external realities.
- **Business Strategy**: It is the managerial plan for achieving the goal of the business unit. However, it should be consistent with the corporate strategy of the firm and should be drawn within the framework provided by the corporate planners.
- **Functional Strategy**: It is the lowest level plan to carry out principal activities of a business. Functional strategy must be consistent with the business strategy, which in turn must be consistent with the corporate strategy.

3. Basic Issues Addressed Under Financial Planning

Financial planning is the backbone of the business planning and corporate planning. It helps in defining the feasible area of operation for all types of activities and thereby defines the overall planning framework. Outcomes of the financial planning are the financial objectives, financial decision-making and financial measures for the evaluation of the corporate performance.

- **Profit Maximization versus Wealth Maximization**: Profit may be an important consideration for businesses but not its maximization because profit maximization as a financial objective suffers from multiple limitations. Wealth maximisation, on the other hand, is measured in terms of its net present value to take care of both risk and time factors. Wealth ensures financial strength of the firm, long term solvency and viability. It can be used, as a decision criterion in a precisely defined manner and can reflect the business efficiency without any scope for ambiguity.

- **Cash Flow**: It deals with the movement of cash and as a matter of conventions, refers to surplus of internally generated funds over expenditures.
- **Credit Position**: It describes its strength in mobilizing borrowed money. In case the internal generation of cash position is weak, the firm may exploit its strong credit position to go ahead in the expansion of its activities.
- **Liquidity Position of the Business**: It describes the extent of idle working capital. It measures the ability of the firm in handling unforeseen contingencies.

4. Interface of Financial Policy and Strategic Management

Financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth.

- Sources of finance and capital structure are the most important dimensions of a strategic plan. The need for fund mobilization to support the expansion activity of firm is utmost important for any business.
- Policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital.
- Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions.
- Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all.

5. Balancing Financial Goals Vis-À-Vis Sustainable Growth

Sustainability means development of the capability for replicating one's activity on a sustainable basis. The weak concept of sustainability requires that the overall stock of capital assets should remain constant. It refers to preservation of critical resources to ensure support for all, over a long time horizon. The strong version is concerned with the preservation of resources under the primacy of ecosystem functioning. In terms of economic dimension, sustainable development rejects the idea that the logistic system of a firm should be knowingly designed to satisfy the unlimited wants of the economic person. A firm has to think more about the collective needs and less about the personal needs. This calls for taking initiatives to modify, to some extent, the human behaviour. The other economics dimension of sustainability is to decouple the growth in output of firm from the environmental impacts of the same.

6. Principles of Valuation

Choice of the degree of sustainability approach for sustainability and modification in the sustainability principle must be based on financial evaluation of the alternative schemes in terms of financial and overall corporate objectives.

- **Valuation Method**: This method depends on demand curve approach by either making use of expressed preferences or making use of revealed preferences.
- **Pricing Method**: This method is a non-demand curve approach that takes into consideration either opportunity costs or alternative costs or shadow projects or government payments or those response methods depending on the nature of the problem and environmental situation.

Valuation methods are in general more complex in implementation than pricing methods. But demand curve methods are more useful for cases where it seems likely that disparity between price and value is high.

Question 1

Discuss the importance of strategic management in today's scenario?

Answer

Importance of Strategic Management

Strategic management intends to run an organization in a systematized fashion by developing a series of plans and policies known as strategic plans, functional policies, structural plans and operational plans. It is a systems approach, which is concerned with where the organization wants to reach and how the organization proposes to reach that position. Thus, strategic management is basically concerned with the futurity of the current decisions without ignoring the fact that uncertainty in the system is to be reduced, to the extent possible, through continuous review of the whole planning and implementation process. It is therefore necessary for an organization interested in long run survival and command over the market, to go for strategic planning and the planning process must be holistic, periodic, futuristic, intellectual and creative with emphasis given on critical resources of the firm otherwise, the organization will fall in the traps of tunneled and myopic vision.

Question 2

Explain the different levels of strategy.

Answer

Strategies at different levels are the outcomes of different planning needs. There are basically three types of strategies:

(a) **Corporate Strategy**: At the corporate level planners decide about the objective or objectives of the firm along with their priorities and based on objectives, decisions are taken on participation of the firm in different product fields. Basically a corporate strategy provides with a framework for attaining the corporate objectives under values and resource constraints, and internal and external realities. It is the corporate strategy that describes the interest in and competitive emphasis to be given to different businesses of the firm. It indicates the overall planning mode and propensity to take risk in the face of environmental uncertainties.

(b) **Business Strategy**: It is the managerial plan for achieving the goal of the business unit. However, it should be consistent with the corporate strategy of the firm and should be drawn within the framework provided by the corporate planners. Given the overall competitive emphasis, business strategy specifies the product market power i.e. the way of competing in that particular business activity. It also addresses coordination and alignment issues covering internal functional activities. The two most important internal aspects of a business strategy are the identification of critical resources and the development of distinctive competence for translation into competitive advantage.

(c) **Functional Strategy**: It is the low level plan to carry out principal activities of a business. In this sense, functional strategy must be consistent with the business strategy, which in turn must be consistent with the corporate strategy. Thus strategic plans come down in a cascade fashion from the top to the bottom level of planning pyramid and performances of functional strategies trickle up the line to give shape to the business performance and then to the corporate performance.

Question 3

Discuss the methods of valuation in brief.

Answer

The evaluation of sustainable growth strategy calls for interface of financial planning approach with strategic planning approach. Choice of the degree of sustainability approach for sustainability and modification in the sustainability principle must be based on financial evaluation of the alternative schemes in terms of financial and overall corporate objectives. There are two alternative methods for evaluation. They are:

(a) **Valuation Method**: Valuation method depends on demand curve approach by either making use of expressed preferences or making use of revealed preferences.

(b) **Pricing Method**: Pricing method is a non-demand curve approach that takes into consideration either opportunity costs or alternative costs or shadow projects or government payments or those response methods depending on the nature of the problem and environmental situation.

Valuation methods are in general more complex in implementation than pricing methods. But demand curve methods are more useful for cases where it seems likely that disparity between price and value is high.

Question 4

Explain briefly, how financial policy is linked to strategic management.

Answer

The success of any business is measured in financial terms. Maximising value to the shareholders is the ultimate objective. For this to happen, at every stage of its operations including policy-making, the firm should be taking strategic steps with value-maximization objective. This is the basis of financial policy being linked to strategic management.

The linkage can be clearly seen in respect of many business decisions. For example :

(i) Manner of raising capital as source of finance and capital structure are the most important dimensions of strategic plan.

(ii) Cut-off rate (opportunity cost of capital) for acceptance of investment decisions.

(iii) Investment and fund allocation is another important dimension of interface of strategic management and financial policy.

(iv) Foreign Exchange exposure and risk management.

(v) Liquidity management

(vi) A dividend policy decision deals with the extent of earnings to be distributed and a close interface is needed to frame the policy so that the policy should be beneficial for all.

(vii) Issue of bonus share is another dimension involving the strategic decision.

Thus from above discussions it can be said that financial policy of a company cannot be worked out in isolation to other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth.

Question 5

Explain the Interface of Financial Policy and Strategic Management.

Answer

The interface of strategic management and financial policy will be clearly understood if we appreciate the fact that the starting point of an organization is money and the end point of that organization is also money. No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and / or preference shares for mobilizing ownership capital.

Along with the mobilization of funds, policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio. However this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization under study.

Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions. A planner has to frame policies for regulating investments in fixed assets and for restraining of current assets. Investment proposals mooted by different business units may be addition of a new product, increasing the level of operation of an existing product and cost reduction and efficient utilization of resources through a new approach and or closer monitoring of the different critical activities.

Now, given these three types of proposals a planner should evaluate each one of them by making within group comparison in the light of capital budgeting exercise.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the firm.

It may be noted from the above discussions that financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies being related to external awareness about the firm, specially the awareness of the investors about the firm, in respect of its internal performance. There is always a process of evaluation active in the minds of the current and future stake holders of the company. As a result preference and patronage for the company depends significantly on the financial policy framework. And hence attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself.

Question 6

Write a short note on Balancing Financial Goals vis-a-vis Sustainable Growth.

Answer

The concept of sustainable growth can be helpful for planning healthy corporate growth. This concept forces managers to consider the financial consequences of sales increases and to set sales growth goals that are consistent with the operating and financial policies of the firm. Often, a conflict can arise if growth objectives are not consistent with the value of the organization's sustainable growth. Question concerning right distribution of resources may take a difficult shape if we take into consideration the rightness not for the current stakeholders but for the future stakeholders also. To take an illustration, let us refer to fuel industry where resources are limited in quantity and a judicial use of resources is needed to cater to the need of the future customers along with the need of the present customers. One may have noticed the save fuel campaign, a demarketing campaign that deviates from the usual approach of sales growth strategy and preaches for conservation of fuel for their use across generation. This is an example of stable growth strategy adopted by the oil industry as a whole under resource constraints and the long run objective of survival over years. Incremental growth strategy, profit strategy and pause strategy are other variants of stable growth strategy.

Sustainable growth is important to enterprise long-term development. Too fast or too slow growth will go against enterprise growth and development, so financial should play important role in enterprise development, adopt suitable financial policy initiative to make sure enterprise growth speed close to sustainable growth ratio and have sustainable healthy development.

The sustainable growth rate (SGR), concept by Robert C. Higgins, of a firm is the maximum rate of growth in sales that can be achieved, given the firm's profitability, asset utilization, and desired dividend payout and debt (financial leverage) ratios. The sustainable growth rate is a measure of how much a firm can grow without borrowing more money. After the firm has passed this rate, it must borrow funds from another source to facilitate growth. Variables typically include the net profit margin on new and existing revenues; the asset turnover ratio, which is the ratio of sales revenues to total assets; the assets to beginning of period equity ratio; and the retention rate, which is defined as the fraction of earnings retained in the business.

SGR = ROE x (1- Dividend payment ratio)

Sustainable growth models assume that the business wants to: 1) maintain a target capital structure without issuing new equity; 2) maintain a target dividend payment ratio; and 3) increase sales as rapidly as market conditions allow. Since the asset to beginning of period equity ratio is constant and the firm's only source of new equity is retained earnings, sales and assets cannot grow any faster than the retained earnings plus the additional debt that the retained earnings can support. The sustainable growth rate is consistent with the observed evidence that most corporations are reluctant to issue new equity. If, however, the firm is willing to issue additional equity, there is in principle no financial constraint on its growth rate.