CHAPTER 1

FINANCIAL POLICY AND CORPORATE STRATEGY

LEARNING OUTCOMES

After reading this chapter student shall be able to understand:

- Strategic Financial Decision Making Frame Work
- Strategy at different hierarchy levels
- Financial Planning
- Interface of Financial Policy and Strategic Management
- Balancing Financial Goals vis-à-vis Sustainable Growth

1. STRATEGIC FINANCIAL DECISION MAKING FRAME WORK

Capital investment is the springboard for wealth creation. In a world of economic uncertainty, the investors want to maximize their wealth by selecting optimum investment and financial opportunities that will give them maximum expected returns at minimum risk. Since management is ultimately responsible to the investors, the objective of corporate financial management should implement investment and financing decisions which should satisfy the shareholders by placing them all in an equal, optimum financial position. The satisfaction of the interests of the shareholders should be perceived as a means to an end, namely maximization of shareholders' wealth. Since capital is the limiting factor, the problem that the management will face is the strategic allocation of limited funds between alternative uses in such a manner, that the companies have the ability to sustain or increase investor returns through a continual search for investment opportunities that generate funds for their business and are more favourable for the investors. Therefore, all businesses need to have the following three fundamental essential elements:

- A clear and realistic **strategy**,
- The **financial** resources, controls and systems to see it through and
- The right **management** team and processes to make it happen.

We may summarise this by saying that:

Strategy + Finance + Management = Fundamentals of Business

Strategy may be defined as the long term direction and scope of an organization to achieve competitive advantage through the configuration of resources within a changing environment for the fulfilment of stakeholder's aspirations and expectations. In an idealized world, management is ultimately responsible to the investors. Investors maximize their wealth by selecting optimum investment and financing opportunities, using financial models that maximize expected returns in absolute terms at minimum risk. What concerns the investors is not simply maximum profit but also the likelihood of it arising: a risk-return trade-off from a portfolio of investments, with which they feel comfortable and which may be unique for each individual.

We call this overall approach strategic financial management and define it as being the application to strategic decisions of financial techniques in order to help achieve the decision-maker's objectives. Although linked with accounting, the focus of strategic financial management is different. *Strategic financial management combines the backward-looking, report-focused discipline of (financial) accounting with the more dynamic, forward-looking subject of financial management.* It is basically about the identification of the possible strategies capable of maximizing an organization's market value. It involves the allocation of scarce capital resources among competing opportunities. It also encompasses the implementation and monitoring of the chosen strategy so as to achieve agreed objectives.

1.1 Functions of Strategic Financial Management:

Strategic Financial Management is the portfolio constituent of the corporate strategic plan that embraces the optimum investment and financing decisions required to attain the overall specified objectives. In this connection, it is necessary to distinguish between strategic, tactical and operational financial planning. While strategy is a long-term course of action, tactics are intermediate plan, while operations are short-term functions. Senior management decides strategy, middle level decides tactics and operational are looked after line management.

Irrespective of the time horizon, the investment and financial decisions functions involve the following functions[1]:

- Continual search for best investment opportunities;

1 Strategic Financial Management: Exercises, Robert Alan Hill.

- Selection of the best profitable opportunities;
- Determination of optimal mix of funds for the opportunities;
- Establishment of systems for internal controls; and
- Analysis of results for future decision-making.

Since capital is the limiting factor, the strategic problem for financial management is how limited funds are allocated between alternative uses. This dilemma of corporate management is resolved by the pioneering work of Jenson and Meckling (1976)[2], which is popularly known as 'agency theory' which you have already studied at your Intermediate (IPC) level. According to this theory, strategic financial management is the function of four major components based on the mathematical concept of expected NPV (net present value) maximization,- Financing decisions; Investment decisions; Dividend decisions; and Portfolio decisions.

The key decisions falling within the scope of financial strategy include the following:

1. **Financing decisions:** These decisions deal with the mode of financing or mix of equity capital and debt capital.

2. **Investment decisions:** These decisions involve the profitable utilization of firm's funds especially in long-term projects (capital projects). Since the future benefits associated with such projects are not known with certainty, investment decisions necessarily involve risk. The projects are therefore evaluated in relation to their expected return and risk.

3. **Dividend decisions:** These decisions determine the division of earnings between payments to shareholders and reinvestment in the company.

4. **Portfolio decisions:** These decisions involve evaluation of investments based on their contribution to the aggregate performance of the entire corporation rather than on the isolated characteristics of the investments themselves. You have already, learnt about the Financing and Investment decisions in your Intermediate (IPC) curriculum, while Dividend and Portfolio decisions would be taken in detail later in this Study Material.

2. STRATEGY AT DIFFERENT HIERARCHY LEVELS

Strategies at different levels are the outcomes of different planning needs. There are three levels of Strategy – Corporate level; Business unit level; and Functional or departmental level.

2.1 Corporate Level Strategy:

Corporate level strategy fundamentally is concerned with selection of businesses in which a company should compete and also with the development and coordination of that portfolio of businesses.

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2 Jensen, M.C> & W.C. Meckling (1976*), "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure",* Journal of Financial Economics, October, V.3,4, pp. 305-360

Corporate level strategy should be able to answer three basic questions:	
Suitability	Whether the strategy would work for the accomplishment of common objective of the company.
Feasibility	Determines the kind and number of resources required to formulate and implement the strategy.
Acceptability	It is concerned with the stakeholders' satisfaction and can be financial and non-financial.

2.2 Business Unit Level Strategy:

Strategic business unit (SBO) may be any profit centre that can be planned independently from the other business units of a corporation. At the business unit level, the strategic issues are about practical coordination of operating units and developing and sustaining a competitive advantage for the products and services that are produced.

2.3 Functional Level Strategy:

The functional level is the level of the operating divisions and departments. The strategic issues at this level are related to functional business processes and value chain. Functional level strategies in R&D, operations, manufacturing, marketing, finance, and human resources involve the development and coordination of resources through which business unit level strategies can be executed effectively and efficiently. Functional units of an organization are involved in higher level strategies by providing input to the business unit level and corporate level strategy, such as providing information on customer feedback or on resources and capabilities on which the higher level strategies can be based. Once the higher level strategy is developed, the functional units translate them into discrete action plans that each department or division must accomplish for the strategy to succeed.

Among the different functional activities viz production, marketing, finance, human resources and research and development, finance assumes highest importance during the top down and bottom up interaction of planning. Corporate strategy deals with deployment of resources and financial strategy is mainly concerned with mobilization and effective utilization of money, the most critical resource that a business firm likes to have under its command. Truly speaking, other resources can be easily mobilized if the firm has adequate monetary base. To go into the details of this interface between financial strategy and corporate strategy and financial planning and corporate planning let us examine the basic issues addressed under financial planning.

3. 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. Financial planning is a systematic approach whereby the financial planner helps the customer to maximize his existing financial resources by utilizing financial tools to achieve his financial goals.

There are 3 major components of Financial planning:

- Financial Resources (FR)
- Financial Tools (FT)
- Financial Goals (FG)

Financial Planning: FR + FT = FG

For an individual, financial planning is the process of meeting one's life goals through proper management of the finances. These goals may include buying a house, saving for children's education or planning for retirement. It is a process that consists of specific steps that helps in taking a big-picture look at where you financially are. Using these steps you can work out where you are now, what you may need in the future and what you must do to reach your goals.

Outcomes of the financial planning are the financial objectives, financial decision-making and financial measures for the evaluation of the corporate performance. Financial objectives are to be decided at the very outset so that rest of the decisions can be taken accordingly. The objectives need to be consistent with the corporate mission and corporate objectives. Financial decision making helps in analyzing the financial problems that are being faced by the corporate and accordingly deciding the course of action to be taken by it. The financial measures like ratio analysis, analysis of cash flow statement are used to evaluate the performance of the Company. The selection of these measures again depends upon the Corporate objectives.

4. INTERFACE OF FINANCIAL POLICY AND STRATEGIC MANAGEMENT

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 i.e. internally and externally mobilized financial base.

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 very vital for any organization. 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 and debentures to raise borrowed capital. Public deposits, for a fixed time period, have also become a major source of short and medium term finance. Organizations may offer higher rates of interest than banking institutions to attract investors and raise fund. The overdraft, cash credits, bill discounting, bank loan and trade credit are the other sources of short term finance.

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 which need to be followed for minimizing the risks of excessive loans. For instance, in case of public sector organizations, the norm is 1:1 ratio and for private sector firms, the norm is 2:1 ratio. However this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization. For capital intensive industries, the proportion of debt to equity is much higher. Similar is the case for high cost projects in priority sectors and for projects in under developed regions.

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 divided into three groups. One type of proposal will be for addition of a new product by the firm. Another type of proposal will be to increase the level of operation of an existing product through either an increase in capacity in the existing plant or setting up of another plant for meeting additional capacity requirement. The last is for 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. In fact, project evaluation and project selection are the two most important jobs under fund allocation. Planner's task is to make the best possible allocation under resource constraints.

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. From the point of view of long term funding of business growth, dividend can be considered as that part of total earnings, which cannot be profitably utilized by the company. Stability of the dividend payment is a desirable consideration that can have a positive impact on share prices. The alternative policy of paying a constant percentage of the net earnings may be preferable from the point of view of both flexibility of the firm and ability of the firm. It also gives a message of lesser risk for the investors. Yet some other companies follow a different alternative. They pay a minimum dividend per share and additional dividend when earnings are higher than the normal earnings. In actual practice, investment opportunities and financial needs of the firm and the shareholders preference for dividend against capital gains resulting out of share are to be taken into consideration for arriving at the right dividend policy. Alternatives like cash dividend and stock dividend are also to be examined while working out an ideal dividend policy that supports and promotes the corporate strategy of the company.

Thus, the 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, especially 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. 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. The nature of interdependence is the crucial factor to be studied and modelled by using an in depth analytical approach. This is a very difficult task compared to usual cause and effect study because corporate strategy is the cause and financial policy is the effect and sometimes financial policy is the cause and corporate strategy is the effect.

5. BALANCING FINANCIAL GOALS VIS-A-VIS SUSTAINABLE GROWTH

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.

What makes an organisation financially sustainable?
To be financially sustainable, an organisation must: ➢ have more than one source of income; ➢ have more than one way of generating income; ➢ do strategic, action and financial planning regularly; ➢ have adequate financial systems; ➢ have a good public image; ➢ be clear about its values (value clarity); and ➢ have financial autonomy.

Source: CIVICUS "Developing a Financing Strategy".

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. Indeed, the sustainable growth rate formula is directly predicted on return on equity.

Economists and business researchers contend that achieving sustainable growth is not possible without paying heed to twin cornerstones: growth strategy and growth capability. Companies that pay inadequate attention to one aspect or the other are doomed to fail in their efforts to establish practices of sustainable growth (though short-term gains may be realized). After all, if a company has an excellent growth strategy in place, but has not put the necessary infrastructure in place to execute that strategy, long-term growth is impossible. The reverse is also true.

The very weak idea of sustainability requires that the overall stock of capital assets should remain constant. The weak version of sustainability refers to preservation of critical resources to ensure support for all, over a long time horizon. The strong concept of sustainability is concerned with the preservation of resources under the primacy of ecosystem functioning. These are in line with the definition provided by the economists in the context of sustainable development at macro level.

What makes an organisation sustainable?
➢ In order to be sustainable, an organisation must:
➢ have a clear strategic direction;
➢ be able to scan its environment or context to identify opportunities for its work;
➢ be able to attract, manage and retain competent staff;
➢ have an adequate administrative and financial infrastructure;
➢ be able to demonstrate its effectiveness and impact in order to leverage further resources; and
➢ get community support for, and involvement in its work.

Source: CIVICUS "Developing a Financing Strategy".

The sustainable growth model is particularly helpful in situations in which a borrower requests additional financing. The need for additional loans creates a potentially risky situation of too much debt and too little equity. Either additional equity must be raised or the borrower will have to reduce the rate of expansion to a level that can be sustained without an increase in financial leverage.

Mature firms often have actual growth rates that are less than the sustainable growth rate. In these cases, management's principal objective is finding productive uses for the cash flows that exist in excess of their needs. Options available to business owners and executives in such cases includes returning the money to shareholders through increased dividends or common stock repurchases, reducing the firm's debt load, or increasing possession of lower earning liquid assets. These actions serve to decrease the sustainable growth rate. Alternatively, these firms can attempt to enhance their actual growth rates through the acquisition of rapidly growing companies.

Growth can come from two sources: increased volume and inflation. The inflationary increase in assets must be financed as though it were real growth. Inflation increases the amount of external financing required and increases the debt-to-equity ratio when this ratio is measured on a historical cost basis. Thus, if creditors require that a firm's historical cost debt-to-equity ratio stay constant, inflation lowers the firm's sustainable growth rate.

Mitsubishi Corporation (MC): New Strategic Direction (charting a new path toward sustainable growth)

Mitsubishi Corporation has abolished its traditional "*midterm management plan*" concept of committing to fixed financial targets three years in the future, in favour of a long-term, circa 2020 growth vision. The "*New Strategic Direction*" consists of basic concepts on management policy together with business and market strategies. It seeks to recognize the Company's value and upside potential as a *sogo shosha* capable of "*providing stable earnings throughout business cycles by managing a portfolio diversified by business model, industry, market and geography*".

MC remains dedicated to sustainable growth but as evidenced by its guiding philosophy, the "Three Corporate Principles", its business activities are even more committed to helping solve problems in Japan and around the world. Its chief goal is to contribute to sustainable societal growth on a global scale.

The summary of this New Strategic Direction is:

- Future pull approach eyeing 2020 with a vision to double the business by building a diversified but focussed portfolio.
- Clear portfolio strategy: Select winning businesses through proactive reshaping of portfolio.
- Grow business and deliver returns while maintaining financial discipline.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. Explain the Interface of Financial Policy and Strategic Management.

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

Answers to Theoretical Questions

1. Please refer paragraph 4

2. Please refer paragraph 5