STRATEGIC FINANCIAL MANAGEMENT

SSEI
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A positive NPV Training Center

FINANCIAL POLICY AND CORPORATE STRATEGY

Quick Revision

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Part 1: STRATEGIC FINANCIAL DECISION MAKING FRAMEWORK

Part A : Introduction		Part B : Functions of Strategic Financial Management	
i.	objective of corporate financial management should implement investment and financing decisions which should satisfy the shareholders	i.	Strategic Financial Management is the portfolio constituent of the corporate strategic plan
ii.	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	ii.	**Strategy** is a long-term course of action, **Tactics** are intermediate plan, **Operations** are short-term functions.
iii.	**all businesses need to have the following three fundamental essential elements:**	iii.	**Irrespective of the time horizon, the investment and financial decisions involve the following functions:**
	a. A clear and realistic **strategy**, **b.** The **financial** resources, controls and systems to see it through and **c.** The right **management** team and processes to make it happen.		• Continual search for best investment opportunities; • 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.
iv.	Strategic financial management combines the backward-looking, report-focused discipline of (financial) accounting with the more dynamic, forward -looking subject of financial management.	iv.	**The key decisions falling within the scope of financial strategy are:** **Financing decisions, Investment decisions, Dividend decisions, Portfolio decisions**
v.	It involves the allocation of scarce capital resources among competing opportunities.		**a. Financing decisions**: deal with the mode of financing or mix of equity capital and debt capital.

	b. 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.
	c. Dividend decisions: These decisions determine the division of earnings between payments to shareholders and reinvestment in the company.
	d. 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.

Part 2: STRATEGY AT DIFFERENT HIERARCHY LEVELS

Part A: Corporate Level Strategy	Part B: Business Unit Level Strategy	Part C: Functional Level Strategy
i. Corporate level strategy fundamentally is concerned with selection of businesses in which a company should compete and with the development and coordination of that portfolio of businesses.	**i.** **Strategic business unit (SBO)** may be any profit centre that can be planned independently from the other business units of a corporation.	**i.** The functional level is the level of the operating divisions and departments.
ii. **Corporate level strategy should be able to answer three basic questions:**	**ii.** At the business unit level, the strategic issues are about	**ii.** The strategic issues at this level are related to functional business processes and value chain.
a. Suitability: Whether the strategy would work for the accomplishment of common objective of the company.	- **practical coordination of operating units** and	**iii.** **It involve the development and coordination of resources** through which business unit level strategies can be executed effectively and efficiently.
b. Feasibility: Determines the kind and number of resources required to formulate and implement the strategy.	- **developing and sustaining a competitive advantage for the products and services** that are produced.	**iv.** Functional units of an organization are **involved in higher level strategies** by providing input to the business unit level and corporate level strategy
c. Acceptability: It is concerned with the stakeholders' satisfaction and can be financial and non-financial.		**v.** 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 .

		vi. 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.**
		vii. **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.

Part 3: FINANCIAL PLANNING

i.	Financial planning is the **backbone of the business planning and corporate planning**.
ii.	It helps in defining the feasible area of operation for all types of activities
iii.	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.
iv.	**There are 3 major components of Financial planning:**
	• Financial Resources (FR) • Financial Tools (FT) • Financial Goals (FG)
v.	**Financial Planning = FR + FT + FG**
vi.	It is a process that consists of specific steps that helps in taking a big-picture look at where you financially are.
vii.	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.
viii.	**Outcomes of the financial planning:**
	• **Financial 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.

Part 4: INTERFACE OF FINANCIAL POLICY AND STRATEGIC MANAGEMENT

i.	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.**
ii.	No organization can run an existing business and promote a new expansion project without a **suitable internally mobilized financial base**
iii.	**Sources of finance and capital structure** are the most **important dimensions** of a strategic plan.

Part A: Generation of Funds
The generation of funds may arise out of ownership capital and or borrowed capital.
Source of Mobilising Funds
• **equity shares and/or preference** shares for mobilizing ownership capital
• **debentures** to raise borrowed capital.
• **Public deposits**, for a fixed time period
• **The overdraft**, **cash credits**, **bill discounting**, **bank loan** and **trade credit** are the other sources of short-term finance.

Part B: Policy Makers Should Decide on The Capital Structure
• There are some norms for debt equity ratio which need to be followed for minimizing the risks of excessive loans.
• In case of **public sector organizations, the norm is 1:1 ratio** and for **private sector firms, the norm is 2:1 ratio.**
• 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 underdeveloped regions.

Part C: Investment and Fund Allocation Decisions.

This is another important dimension of strategic management and financial policy interface

- 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.
- Two most important jobs under fund allocation
  - Project evaluation
  - project selection
- Planner's task is to make the best possible allocation under resource constraints.

Part D: Dividend Policy

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company.

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.

Different alternatives to pay dividend are

- Paying constant amount of dividend
- Paying constant percentage of dividend
- They pay a minimum dividend per share and additional dividend when earnings are higher than the normal earnings.
- Cash dividend and stock dividend

Part E: Conclusion
• 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.
• 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.**

Part 5: BALANCING FINANCIAL GOALS VIS-A-VIS SUSTAINABLE GROWTH

Part A: Basic	Part B: Sustainable growth model, rate	Part C: Other Questions
i. The concept of sustainable growth can be **helpful for planning healthy corporate growth.**	**1. The sustainable growth rate (SGR)**	**1. What makes an organisation financially sustainable?**
ii. Conflict can arise if growth objectives are not consistent with operating and financial policy.	**i.** **SGR** is the maximum rate of growth in sales that can be achieved	• 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.
iii. Conflict can arise when we take into consideration the rightness not for the current stakeholders but for the future stakeholders also.	**ii.** The sustainable growth rate is a measure of how much a firm can grow without borrowing more money.	
iv. **Illustration:** In case of oil companies fuel is limited resources so save fuel campaign can help to survive over longer years. **This is example of stable growth strategy.**	**iii.** After the firm has passed this rate, it must **borrow funds from another source to facilitate growth**.	
v. **Other variants of stable growth strategy:**	**iv. SGR = ROE x (1- Dividend payment ratio)**	**2. What makes an organisation sustainable?**
- Incremental growth strategy	**2. Sustainable growth model**	• 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;
- profit strategy	**i. It assume that the business wants to**	
- pause strategy	**a.** maintain a target capital structure without issuing new equity;	
	b. maintain a target dividend payment ratio;	

	c. increase sales as rapidly as market conditions allow	• 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.
	ii. Hence firms only source to grow is retained earnings	
	iii. The sustainable growth model is particularly **helpful in situations in which a borrower requests additional financing.**	
	3. Other Points	
	i. Achieving sustainable growth is not possible without paying heed to twin cornerstones: **growth strategy and growth capability.**	
	ii. Growth can come from two sources: **increased volume and inflation**	