

Financial Policy and Corporate Strategy

BASIC CONCEPTS AND FORMULAE

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

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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

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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.