Star Rating

On the basis of Maximum marks from a chapter	Nil
On the basis of Questions included every year from a chapter	Nil
On the basis of Compulsory questions from a chapter	Nil

CHAPTER

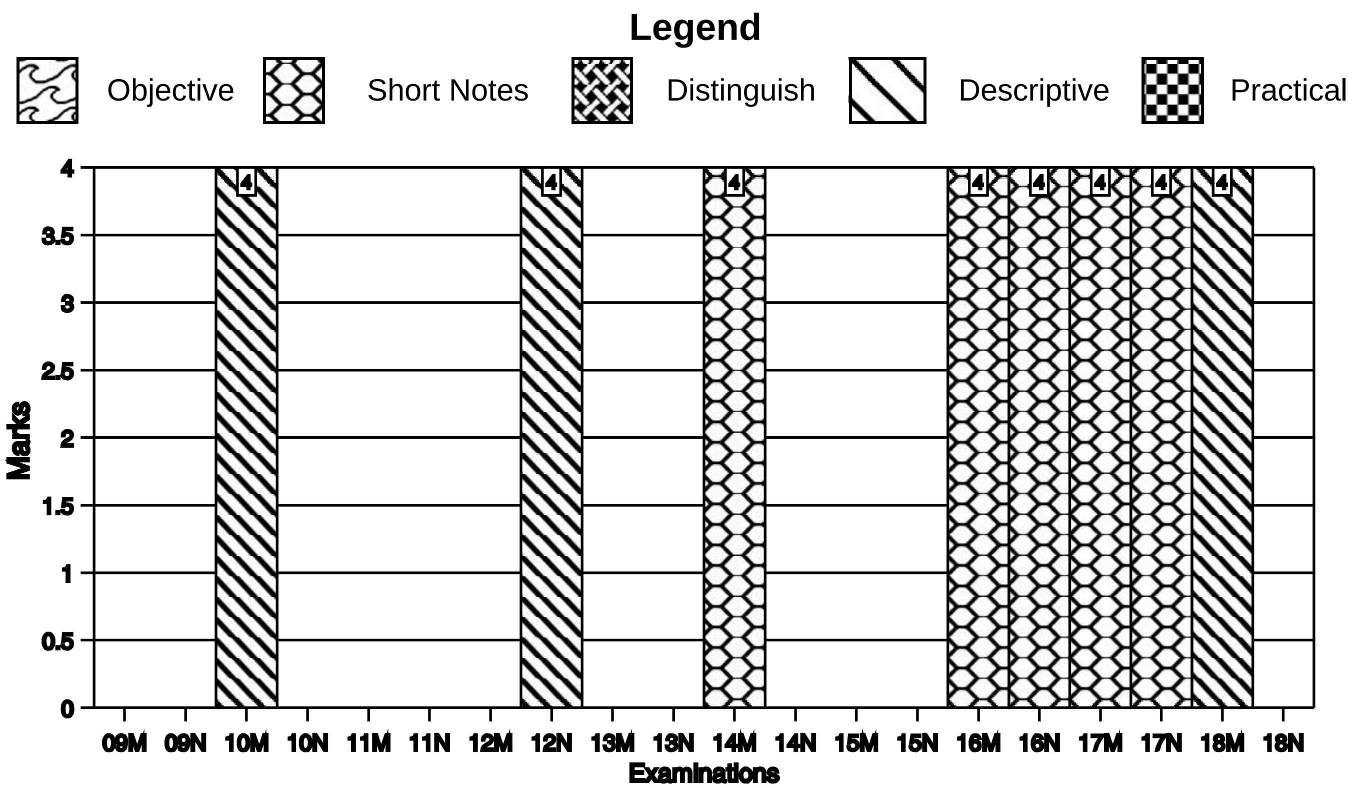
1

Financial Policy and Corporate Strategy

THIS CHAPTER COMPRISES OF

☞ 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

Marks of Short Notes, Distinguish Between, Descriptive & Practical Questions



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◗ SHORT NOTES

2014 - May [7] Write short note on the following:

(e) Balancing Financial Goals vis-a-vis Sustainable Growth. (4 marks)

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

  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.

Space to write important points for revision

2016 - May [7] Write short note on the following:

(e) Interface of financial policy and strategic management. (4 marks)

Answer:

Please refer 2012 - Nov [7] (a) on page no. 20

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2016 - Nov [7] Write short note on the following:

(e) What makes an organization sustainable? State the specific steps. (4 marks)

Answer:

Meaning: Sustainable growth rate 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 ratios.

Steps:

1. **Objectives:** In sustainable growth model following objectives needs to be define:
   (a) Maintain a target capital structure without new equity.
   (b) Maintain a target Dividend Payment Ratio, and
   (c) Increase Sales as rapidly as market conditions allow.
2. **Variables:** Variables in sustainable growth are:
   (a) Net profit margin on new and existing revenue.
   (b) Asset turnover ratio
   (c) Assets to beginning of period equity ratio, and
   (d) Retention Rate.
3. **Variants:** Incremental growth strategy, profit strategy and pause strategy and other variants of stable/sustainable growth strategy needs to be defined and implemented.
4. **Analysis:** If a firm has actual growth rate that are less then SGR model, then Management's principal objective is:
   (a) To find out productive uses for the cash flow that exist in excess of their needs.
   (b) To enhance their actual growth rates through the acquisition of rapidly growing companies.

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2017 - May [7] Write short note on the following:

(a) What makes an organisation financially sustainable? (4 marks)

Answer :

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.

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2017 - Nov [7] Write short notes on the following:
(a) Various processes of strategic decision making (4 marks)
Answer:
Mintyberg, Raisinghani, and Theoret, provided a model of the process of strategic decision - making and identified following three major phases with sub-routines or sub-phases within each.
These are:
1. **Identification Phase**
   (a) Decision Recognition Routine:
   To identify opportunities, problems, and crisis to commence decisional activity.
   (b) Diagnosis Routine:
   To collect information relevant to opportunities, problems, and crisis to identify problems more clearly.
2. **Development Phase**
   (a) Search Routine:
   To generate alternative solutions to problems.
   (b) Design Routine:
   To design new solutions to problems on hand, and to adopt or modify previously identified ready - made solutions.
3. **Selection Phase:**
   (a) Screen Routine:
   This is required when the search routine identifies more alternatives than can be intensively evaluated alternatives are quickly scanned and the infeasible ones are eliminated.

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◗ DESCRIPTIVE QUESTIONS

2010 - May [1] (c) Explain briefly, how financial policy is linked to strategic management. (4 marks)
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 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) Liquidity management

(v) 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.

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

Thus from above discussions it can be said that financial policies. it has a wider appeal and closer link with the overall organizational performance and direction of growth.

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2012 - Nov [7] Answer the following :

(a) Interface of Financial Policy and Strategic Management. (4 marks)

Answer :

"The starting point of an organization is money and the end point of that organization is also money." - This fact must be appreciated so that the interface of strategic management and financial policy will be clearly understood. 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.

- Alongwith 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***. These are aimed at minimizing the risks of excessive loans, ***for 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 under study. 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.

- 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.
- At the time of 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.
- Whereas this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization under study.
- Other 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.
- On the basis of the aforesaid 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.
- On the basis of aforesaid points 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.
- It should attract, the attention of the corporate planners while framing the financial policies not at a later stage but during the stage of corporate planning itself.

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2018 - May [2] (c) Explain the interface of Financial Policy and Strategic Management. (4 marks)

Answer:

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 organisation is money and the end point of that organisation is also money. No organisation can run an existing business and promote a new expansion project without a suitable internally mobilized 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 highest 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 requirements. 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 constrains.
- 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 stakeholders 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 modeled 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.

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Similarly Asked Questions				
No.	Category	Question	Marks	Frequency
1	Descriptive/ Short notes	Interface of financial policy and strategic management. 12 - Nov [7] (a), 16 - May [7] (e)	4, 4	2 Times