UNIT 88 – UPSC - Corporate Financial Policies and Strategy

Corporate financial strategy is a business method in which financial mechanisms are used to evaluate the expected success and consequences of projected business strategies and projects. Financial policies and strategies of corporation are associated with the raising and use of funds. A corporation's financial policy denotes to the company's overall approach to manage its financial decisions. A company's financial strategy is composed of Capital budgeting, financing and dividend policy. While every corporation typically deals with these three areas when setting its financial policies, each organization must examine many factors that are unique to its business and situation before setting up its overall policies. Management literature denotes that In order to thrive in a global financial market, firms' managers must be capable of delivering good strategy to the stock analysts and, ultimately, share value to the money managers (Useem, 1998,).

Major aim of these policies is to safeguard adequate and regular supply of capital to the organization, keeping the present and future requirements of business in mind. Capital of course should not only be satisfactory but should also be sensibly employed. Extravagant use of capital is as bad as insufficient capital. Therefore, while assessing fixed and working capital requirements, the types of securities to be issued, the sources to be exploited financial executives should know the proper use of funds. While confirming financial plans, all contingencies should be taken into account. It must be remember that there is no loss of the business due to excess or shortage of funds.

Furthermore, the cost of raising capital should be minimum. There should always be a good balance between fixed cost bearing securities (debentures and preference shares) and variable cost bearing securities (equity shares). After procuring the funds, they must be employed effectively. Liquidity, safety and profitability should be the guiding factors in this regard. Trends in building corporate financial policies have been altering over the past decade. While investors and shareholders want to make certain that there is capital available to grow the business, shareholders are increasingly comfortable in amassing debt to do so. In present marketplace, corporate managers and investors look for short-term gains as opposed to more traditional long-term financial strategies.

In current business environment, corporate leaders and decision makers use numerous corporate financial strategy to:

1. Actively improve shareholder value
2. Fundraise
3. Achieve venture capital
4. Promote corporate progress.

Firms stimulate growth through organic or inorganic business actions. Corporate progress refers to economic enlargement as measured by number of indicators such as: Increased revenue, staffing, and market share. Issues that affect corporate value and growth include human capital, intellectual property, change management, and investment funding. Growth corporations tend to have an operating business plan that give direction to the company toward growth choices and activities. An operating business plan denotes to a dynamic document that emphasizes the strengths and weakness of the company and guides the company toward learning and improved efficiency. A company's operating business plan is informed and determined by its corporate financial strategy.

The arena of corporate financial strategy brings together the forces of corporate finance and corporate strategy to compliment and balance one another. In successful corporate finance strategy, corporate finance and strategy functions work together to generate shareholder value. Corporate financial strategy is a multi-faceted and multi-field method to business actions and management. The history of finance and strategy in corporate settings has been one of divisiveness and territoriality.

Since earlier time, finance and strategy, and financial and strategic decision making have been considered separate intelligent and decision-making forces.

Chief financial officers favour either finance or strategy as their main decision making influence. For instance, chief financial officers and managers that favour economic or finance-based decision-making may depend on managerial economics or applied economics to make business decisions. Finally, there is no considerable conflict between corporate finance and corporate strategy tools and instruments. Finance and strategy, which have a history of being separate activities in the corporate area are complimentary functions that have the potential to strengthen and balance one another. Corporations that assimilate finance and strategy functions have maximum opportunities for development and value added actions (Thackray, 1995).

Multinational companies in twenty-first century, share many of the same physiognomies. For example, the contemporary corporation is usually organized into business units. Each business unit within the modern corporation is accountable for its' own profits or losses. Business planning is generally dispersed. Business unit product line managers concentrate on revenues for single products over the shorter term. Speedy development and innovation in information technology continues to change production functions and the nature of the products and services sold and delivered to customers (Egan, 1995).

Despite the resemblances that characterize modern corporations, corporations do vary in their ability to conglomerate finance and strategy factors. In the progressively competitive global market, successful incorporation between finance and strategy dimensions may mean the difference

between corporate success and corporate catastrophe. Chief financial officers, managers, and planning teams that use financial strategy as their decision-making compass may create more capital and growth for their companies and shareholders as compared to those corporations that base their business decisions on either finance or strategy.

In financial strategy, finance is a major source of strength to gain distinctive competitive advantages to a company. Companies that manage their stocks, debtors and creditors will improve their cash flow and reduce both operating and borrowing expenses. They can borrow at competitive rates and reduce interest payments to a significant extent. Large finances help them to move ahead of competitors with confidence. Resources can be leveraged to upsurge the returns for shareholders. They can increase their scale of operations and derive significant tax concessions through mergers and acquisitions. In this way, companies that manage their funds well can develop distinct competitive advantages over a period of time.

Good financial strategy is needed to maintain an adequate cash flow to keep the business operating and also for development.

There are numerous factors related with planning and executing a corporate financial policy. In previous time, companies have focused on both short-term and long-term planning when defining financial policies. Conventional knowledge indicates that investors favour companies with good details or a strong balance sheet. Firms are faced with many decisions related to how to grow and finance their operations. There are some factors that companies must consider when devising their financial strategy:

-Since the interest on debt is deductible, does it make sense to borrow more?
-Best thing to do with excess cash.
Whether cash be used to finance the business or returned to shareholders.

Numerous steps to develop effective Corporate Financial Strategy:

Corporate financial strategy is most efficacious when the strategy is maintained internally and aligned with the operations of the company. Fully combined corporate financial strategies can be developed using the following steps (Mallette, 2005):

I. Develop a sufficient capital structure: Capital structure is described as the means through which a company finances itself. Financing may come from long term-debt, common stock, and retained earnings. Companies can determine the best capital structure for its purposes through the use of three forms of analyses: Downside cash flow scenario modeling, peer group analysis, and bond rating analysis. Downside cash flow scenario modelling is a procedure in which a capital structure is taken from a set of downside cash flow scenarios. Peer group analysis is a process in which common capital structures and fads of peer businesses, are assessed for insight into operating features. Bond rating analysis is a process in a review of the debt capacity within certain debt ratings.
II. Determine the correct market valuation: Correct market valuation appraises whether the company is underrated or overvalued in the marketplace. Market valuation is described as a measure of how much the business is worth in the marketplace. It is important to

review financial measures such as investor expectations for growth, margins, and investments. Compare investors' expectations and managements' expectations to check for discrepancy.

III. Establish the best corporate financial strategy: Develop an ideal strategy for value creation that provides sufficient funding, financial balance, and a growing cash reserve.

It is well realized that corporate financial strategy is a firm-specific enterprise. Firms create their individual corporate financial strategies based on their available tools, resources, insights, goals, and objectives.

Applications:

In corporation, Chief financial officers, managers, and planning teams design their corporate financial strategies to exploit and optimize growth and shareholder value. Corporate financial strategies are considered as return driven policies. A return driven corporate strategy are a set of corporation specific guidelines for creating, maintaining, and analysing corporate strategy focused on highest, long-range wealth development. In today's business climate, managers have more responsibility to create shareholder value, observe the performance of a business, and maintain long-term business success. Return driven corporate financial strategy prioritizes value added outcomes and directs the business with a critical eye toward return, value, and growth (Frigo, 2003).

Common mechanisms of corporate financial strategies include: Value-based management, strategic planning, mergers and acquisitions, cost analysis, and capital budgets which are used by chief financial officers, managers, and planning teams to create shareholder value.

Corporate strategies and Value-Based Management:

Chief financial officers, managers, and planning teams of firms may select to base their corporate financial strategy on the philosophies of value-based management. Value-based management is expounded as a management approach focused on maximizing shareholder value. Value-based management includes strategies for creating, measuring, and managing value. Value-based management is a combined and holistic approach to business that embraces and informs the corporate culture, corporate communications, corporate mission, corporate strategy, corporate organization, corporate decision making, and corporate awards and compensation packages.

The economic value added strategy is general mechanism used in value-based management. Economic value added is the net operating profit minus a charge for the opportunity cost of all the capital invested in the project. Economic value added analysis is measured a useful process for looking at varying company unit performances on a cost-of-capital basis where risks are attuned. Value added managers may receive compensation based on the outcome of economic value added analysis. Finally, the economic value added approach is a measure of economic performance and a strategy for building shareholder wealth (Bhalla, 2004).

To summarize, financial strategy of corporation concerns how companies raise and deploy their funds. The investor's required return can be mapped against their perceived risk. It is associated with delivering value for shareholders which is the main financial objective of a company.