1 FINANCIAL POLICY & CORPORATE STRATEGY

Question 1

Discuss briefly the key decisions falling within the scope of financial strategy.

(MTP 4 Marks Oct'19, Apr'21, PYP 4 Marks Nov'19, PYP 4 Marks Jan'21, RTP Nov'20)

OR

As a financial strategist you will depend on certain key financial decisions. Discuss.

(MTP 4 Marks Mar'23)

Answer :

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.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Most of the examinees attempted the theoretical question correctly and hence performance was very good.

Question 2

"Sustainable growth is important to enterprise long-term development". Explain this statement in context of planning healthy corporate growth.

(MTP 4 Marks Oct' 20 & March' 24)

Answer :

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) 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.

Question 3

Explain the specific steps that make an organization sustainable.

(MTP 4 Marks Mar' 21)

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.

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.

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.

Question 4

Discuss on Balancing Financial Goals vis-a-vis Sustainable Growth.

(MTP 4 Marks Apr'19, Aug'18, Sep'22, RTP May'20, Old & New SM)

OR

Often, a conflict can arise if growth objectives are not consistent with the value of the organization's sustainable growth. EXPLAIN. **(MTP 4 Marks, Mar'22)**

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.

Sustainable Growth Rate

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 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)

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1) maintain a target capital structure without issuing new equity:
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Since the asset to beginning of pests cannot grow any faster and the firm's only source of new equity is Since ed earnings, sales and assets Cappotere asus faster than the retained earnings plus the a equity is debt that the retained earnings care reluctant to isseinable growth rate is consistent with the additional debt thee that most corporations are reluctant this conte equity. If, however, the firm is willing to issed evoditional 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 reasearches 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 Pas 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.

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 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 re-quired 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.

Question 5

Financial Resources, Financial Tools and Financial Goals are outcomes of Financial Planning. Do you agree with this statement?

(MTP 4 Marks Nov'21, PYP 4 Marks May'22)

Answer :

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. Financial Resources, Financial Tools and Financial Goals are not the outcomes of Financial Planning rather these are compo-nents of Financial Planning.

Outcomes of the financial planning are as follows:

- **Financial objectives:** 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:** It 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.
- **Financial measures:** It includes ratio analysis, analysis of cash flow statement etc. to evaluate the performance of the Company. The selection of these measures again depends upon the corporate objectives.

Question 6

EXPLAIN what makes an organization financially sustainable.

(MTP 4 Marks, April'22, RTP May'21)

Answer :

To be financially sustainable, an organization 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.

Question 7

EXPLAIN outcomes of the Financial Planning.

(MTP 4 Marks Oct' 22)

Answer :

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 is used to evaluate the performance of the Company. The selection of these measures again depends upon the corporate objectives.

Question 8

Explain the term Corporate Level Strategy and what are the three basic questions it answers? **(MTP 4 Marks Sep' 23)**

OR

What do you mean by Corporate Level Strategy. Also explain three basic questions Corporate Level Strategy should be able to answer.

(MTP 4 Marks April'24) (PYP 4 Marks Nov'23)

Answer :

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. Corporate level strategy should be able to answer three basic questions:

(1) **Suitability:** Whether the strategy would work for the accomplishment of common objective of the company.

(2) **Feasibility:** Determines the kind and number of resources required to formulate and implement the strategy.

(3) **Acceptability:** It is concerned with the stakeholders' satisfaction and can be financial and non-financial.

Question 9

What makes an organization sustainable as well as financially sustainable?

(MTP 4 Marks Oct'23, PYP 4 Marks May'23)

OR

Explain the various requirements that makes an organization sustainable.

(MTP 4 Marks April'23)

Answer :

In order to be sustainable, an organization 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.

To be financially sustainable, an organization 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.

Question 10

State the strategy at different hierarchy levels. **(PYP 4 Marks July'21)**

Answer :

Strategies at different levels are the outcomes of different planning needs.

Three levels of Strategy - Corporate level; Business unit level; and Functional or departmental level.

(1) **Corporate Level Strategy:** 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.

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) **Business Unit Level Strategy:** Strategic business unit (SBO) may be any profit center 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.

(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, fi-nance assumes highest importance during the top down and bottom-up Interaction of planning. Corporate strategy deals with deployment of resources and financial strategy are 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.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Though overall above average performance has been noticed in this theoretical question but in some cases, students have mentioned different levels instead of strategies and even headings of strategies at different levels were correctly mentioned but explanation to these points were very generic in nature.

Question 11

What is sustainable growth rate?

(i) What makes an Organization Sustainable?

(ii) Mr. X has submitted the following data:

Particulars	(₹) In Lakhs
Total Assets	250
Total Liabilities	220
Net Income	12
Dividend Paid	4.5
Sales	100

Mr. X wants to know to what extent sales can be increased without going for additional borrowings by using Sustainable Growth Rate (SGR) concept?

(PYP 8 Marks Nov 22)

Answer :

(i) 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.

(ii) In order to be sustainable, an organization 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.

(iii)

SI.No.	Particulars	Amount in ₹ Lakhs
(a)	Total Assets	250.00
(b)	Total Liabilities	220.00
(c)	Net Income	12.00
(d)	Dividend Paid	4.50
(e)	Sales	100.00
(f)	Equity (a) – (b)	30.00
(g)	Return on Equity (ROE) (C) / (f)	40.00%
(h)	Dividend pay-out Ratio (d) / (c)	37.50%
(i)	SGR [g x (1-h)]	25.00%*
(j)	Additional Sales can be achieved without further borrowings (e) × (j)	25.00
(k)	Maximum sales can be achieved without further borrowings (e) + (j)	125.00

* Alternatively, it can also be computed as follows:

SGR = $\frac{g(1-h)}{1-[g(1-h)]}$ = 33.33% and the additional sales shall be ₹ 33.33 Lakhs and

Maximum Sales can be achieved without further borrowings shall be ₹ 133.33 Lakhs

Question 12

Explain the Interface of Financial Policy and Strategic Management.

(Old & New SM, PYP 4 Marks May'18)

Answer :

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 pronote 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 ation The equity shares and/or preference shares for mobilizing ownership capital and debentures to raise may issue equital. Public deposits, for a fixed timeriod, have also become a major source of short and medium capit 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 underdeveloped 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 pro-posal 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 an-other 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 prefer-able 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 porate planners must be drawne 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.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

In this theoretical question, performance was of above average level.

Question 13

In the current scenario of globalization and growth in information and communication technologies etc. the responsibilities of CFOs have been drastically expanded. Explain. (Chapter Financial Policy and Corporate Strategy)

(RTP May'24)

Answer :

Traditionally, the main role of CFO was concentrated to wealth maximization for shareholders by taking care of financial health of anorganization and overseeing and implementing adequate financial controls.

However, in recent time because of globalization, growth in information and communications, pandemic situation etc. their range of responsibilities has been drastically expanded, driven by complexity, and changing expectations.

Now a days in addition to fulfilling traditional role relating to governance, compliances and controls, and business ethics as a part of the leadership of role CFOs are also expected to contribute their supportin strategic and operational decision making.

In post-pandemic time their role has been advanced in the following areas in addition to traditional role:

a. **Risk Management:** Now a days the CFOs are expected to look after the overall functioning of the framework of Risk Management system of an organization.

b. **Supply Chain:** Post pandemic supply chain management system has been posing the challenge for the company to maintain the sustainable growth. Since CFOs are care takers of finance of the company, considering the financial viability of the Supply Chain Management their role has now become more critical.

c. **Mergers, acquisitions, and Corporate Restructuring:** Since in recent period to maintain the growth and capture the market share there has been a spate of Mergers and Acquisitions and hence the role of CFOs has become more crucial because these are strategic decision and any error in them can lead to collapse of the whole business.

d. **Environmental, Social and Governance (ESG) Financing:** With the evolving of the concept of ESG their role has been shifted from traditional financing to sustainability financing.

Thus, from above discussion it can be concluded that in today's time CFOs are taking a leadership role in Value Creation for the organization and that too on sustainable basis for a longer period.

Question 14

AB Industries has Equity Capital of ₹ 12 Lakhs, total Debt of ₹ 8 takhs, and annual sales of ₹ 30 Lakhs.

Two mutually exclusive proposals are under consideration for the next year. The details of the proposals as under:

Particulars	Proposal no. 1	Proposal no. 2
Target Assets to Sales Ratio	0.65	0.62
Target Net Profit Margin (%)	4	5
Target Debt Equity Ratio (DER)	2:3	4:1
Target Retention Ratio (of Earnings) (%)	75	-
Annual Dividend (₹ In Lakhs)	-	0.30
New Equity Ralsed (₹ in Lakhs)	-	1

You are required to calculate sustainable growth rate for both the proposals.

(PYP 8 Marks Nov '20)

Answer:

Sustainable Growth Rate under Proposal 1

Sales (Given)		₹ 30 Lakhs
Total Assets	₹ 30 Lakhs × 0.65	₹ 19.50 Lakhs
Net Profits	₹ 30 Lakhs × 4%	₹ 1.20 Lakhs
Equity Multiplier	Equity = 12 Lakhs Equity + Debt 12 Lakhs + 8 Lakhs	0.6
ROE	$\frac{1.20 \text{ Lakhs}}{19.50 \text{ Lakhs}} \times 0.60 \times 100$ Sustainable Growth Rate = ROE x Retention Ratio = 3.69% × 0.75 = 2.77%	3.69%

Sustainable Growth Rate under Proposal 2

New equity = ₹ 12 Lakhs + ₹ 1 Lakh = ₹ 13 Lakhs New Debt = ₹ 13
Lakhs × 4 = ₹ 52 Lakhs
Total Assets = ₹ 13 Lakhs + ₹ 52 Lakhs = ₹ 65 Lakhs

Total Assets to Sales Ratio (Given)		0.62
Sales	₹ 65 Lakhs / 0.62	₹ 104.84 Lakhs
Net Profit	₹ 104.84 Lakhs × 5%	₹ 5.242 Lakhs

Equity Multiplier $= \frac{\text{Equity}}{\text{Equity+Debt}} = \frac{\text{13 Lakhs}}{\text{13 Lakhs + 52 Lakhs}}$ 0.2

ROE $= \frac{\text{5.242 Lakhs}}{\text{65 Lakhs}} \times 0.20 \times 100$ 1.613%

Retention Ratio $= \frac{\text{5.242 Lakhs} - \text{0.30 Lakhs}}{\text{5.242 Lakhs}}$ 0.943

Sustainable Growth Rate = ROE × Retention Ratio

= 1.613% × 0.943

= 1.52%