Star Rating

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

CHAPTER

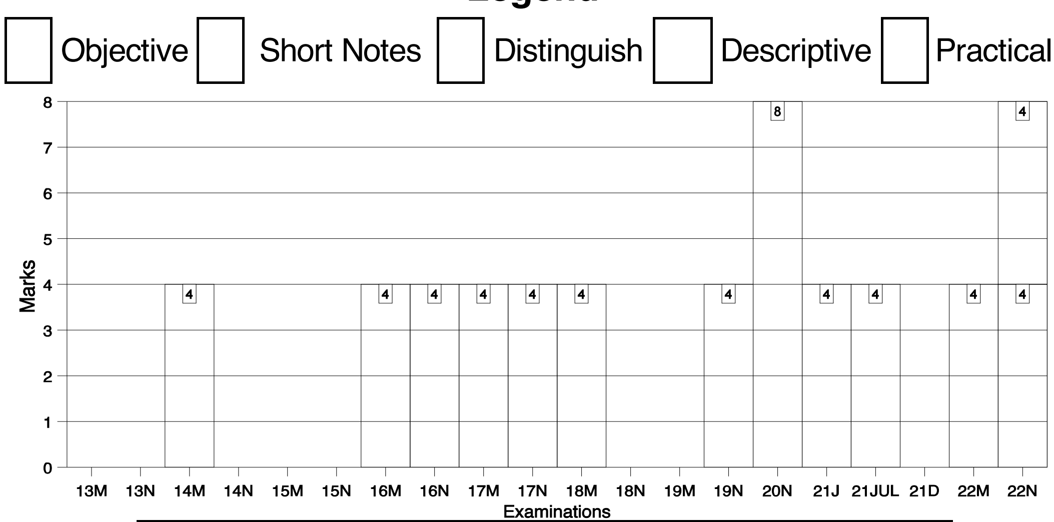
1 Financial Policy and Corporate Strategy

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

Legend



For detailed analysis Login at *www.scanneradda.com*
for registration and password see first page of this book.

SCAN WITH CAMERA OF YOUR PHONE

Scan QR Code for Additional Material

SHORT NOTES

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

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

Answer:

Balancing Financial Goals *vis-a-vis* Sustainable Growth:

- 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 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.

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

(e) 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.

Space to write important points for revision

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.

What makes an organisation sustainable:

- 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;
- 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.

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.

—— Space to write important points for revision ——

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.

—— Space to write important points for revision ——

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.

Space to write important points for revision

DESCRIPTIVE QUESTIONS

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

Answer:

Please refer 2016 - May [7] (e) on page no. 18

Space to write important points for revision

2019 - Nov [5] (c) Discuss briefly the key decisions which falls within the scope of financial strategy. (4 marks)

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 decision**	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 investment themselves.

Space to write important points for revision

2021 - Jan [1] {C} (c) As a financial strategist you will depend on certain key financial decisions. Discuss. (4 marks)

Answer:

The key decisions falling within the scope of financial strategy are 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.

—— Space to write important points for revision ——

2021 - July [1] {C} (c) State the strategy at different hierarchy levels.

(4 marks)

Answer:

There are 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 business in which a company should complete and with the development and coordination of that portfolio of business.

   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 (SBU) may be any profit centre 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 strategy is developed, the functional units translate them into discrete action plans that each department or division must accomplish for the strategy to succeed.

—— Space to write important points for revision ——

2022 - May [2] (c) Explain the outcomes of Financial Planning. (4 marks)

Answer:

- **Outcomes of Financial Planning are:**
  (i) 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.

  (ii) Financial Decision Making:
  - 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.

  (iii) Financial Measures:
  - The financial measures like ratio analysis, analysis of cash flow statement etc., are used to evaluate the performance of the company. The selection of these measures again depends on the corporate objectives.

—— Space to write important points for revision ——

2022 - Nov [6] (b) (i) What is Sustainable Growth Rate?

(ii) What makes an Organization Sustainable? (2 marks each)

PRACTICAL QUESTIONS

2020 - Nov [2] (a) AB Industries has Equity Capital of ₹ 12 Lakhs, total Debt of ₹ 8 Lakhs, and annual sales of ₹ 30 Lakhs. Two mutually exclusive proposals are under consideration for the next year. The details of the proposals are 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
Net Equity Raised (₹ in Lakhs)	–	1

You are required to calculate sustainable growth rate for both the proposals. (8 marks)

Answer:

Sustainable Growth Rate under Proposal 1:

Sales (Given)		₹ 30 Lakhs
Total Assets	₹ 30 Lakhs × 0.65	₹ 19.50 Lakhs
Net Profit	₹ 30 Lakhs × 4%	₹ 1.20 Lakhs

Equity Multiplier	$\frac{\text{Equity}}{\text{Equity} + \text{Debt}} = \frac{12\,\text{Lakhs}}{12\,\text{Lakhs} + 8\,\text{Lakhs}}$	0.6
ROE	$\frac{1.20\,\text{Lakhs}}{19.50\,\text{Lakhs}} \times 0.60 \times 100$	3.69%

Sustainable Growth Rate = ROE × Retention Ratio
= 3.69% × 0.75 = 2.77%

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

Target 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	$\frac{\text{Equity}}{\text{Equity} + \text{Debt}} = \frac{13\,\text{Lakhs}}{13\,\text{Lakhs} + 52\,\text{Lakhs}}$	0.2
ROE =	$\frac{5.242\,\text{Lakhs}}{65\,\text{Lakhs}} \times 0.20 \times 100$	1.613%
Retention Ratio	$\frac{5.242\,\text{Lakhs} - 0.30\,\text{Lakhs}}{5.242\,\text{Lakhs}}$	0.943

Sustainable Growth Rate = ROE x Retention Ratio
= 1.613% × 0.943 = 1.52%

—— Space to write important points for revision ——

2022 - Nov [6] (b) (iii) 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?

(4 marks)

Similarly Asked Questions				
No.	Category	Question	Marks	Frequency
1	Descriptive/ Short notes/ Descriptive	Interface of financial policy and strategic management. 16 - May [7] (e), 18 - May [2] (c)	4, 4	2 Times
2	Short Notes/ Descriptive	What makes an Organization Sustainable? 16 - Nov [7] (e), 22 - Nov [6] (b) (ii)	4, 2	2 Times

Table Showing Marks of Compulsory Questions										
Year	18 M	18 N	19 M	19 N	20 N	21 J	21 J	21 D	22 M	22 N
Descriptive						4	4			
Total						4	4			