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THE UNDERLYING CONCEPTS OF STRATEGIC FINANCIAL MANAGEMENT

Abstract
This paper discusses the concept of Strategic Financial Management with theoretical explanations of underlying concepts. There is an effort to throw light on different aspects of the concept so as to provide a base for further work. In the review of literature, two papers have been discussed each with a rich bibliography and precedents. The review is narrowly focused on interrelationship between capital structure decision of a firm & its competitiveness under conditions of environmental uncertainty & another one reviews the work done to study the link between strategy variables & capital structure. The term paper is based on the knowledge obtained from earlier research work in the domain & academic text books.

Introduction

Strategic Financial Management, SFM constitutes the syllabus of MBA course at the International Institute of Paris, 2ip, France. It involves a happy blending of basic conceptual frameworks of two disciplines to provide a strategic approach towards the management of financial resources of an enterprise. It intends to facilitate optimal results in financial implications of strategic decisions as well as strategic repercussions of decisions on financial status of the enterprise over an enterprise It relates to long term management of funds As the name suggests, SFM derives its base from rules & principles of two disciplines namely Strategic management & Financial Management.

It can be called an extension of financial management theory to a strategic perspective. When the strategic approach is incorporated to the financial decision making process, it lends an element of bounded rationality to the “rational” process of financial management which works on the sole objective of wealth maximization of capital providers of the firm. Owing to the fact that financial decisions of every firm has strategic implications i.e. on product market performance of the firm & its competitive position(often contradictory), the importance of alignment of two has been acknowledged by decision makers. One benefit of these contradictory results has been to stimulate research beyond the confines of Finance and economics into the broader sphere of strategic management. Before we proceed, it’s imperative to make some points clear & bring out the general meaning of relevant terms, to finally lay down the

points of difference between strategic management & finance theory & then move towards integration of the two actions an organization undertakes in order to create and sustain competitive advantages.

1. The strategic management of an organization entails three ongoing processes: analysis, decisions, and actions. That is, strategic management is concerned with the analysis of strategic goals (vision, mission, and strategic objectives) along with the analysis of the internal and external environment of the organization. Next, leaders must make strategic decisions. These decisions, broadly speaking, address two basic questions: What industries should we compete in? How should we compete in those industries? These questions also often involve an organization's domestic as well as its international operations. Decisions are of little use, of course, unless they are acted on. Firms must take the necessary actions to implement their strategies. This requires leaders to allocate the necessary resources and to design the organization to bring the intended strategies to reality.
2. How should we compete in order to create competitive advantages in the marketplace?
3. How can we create competitive advantages in the marketplace that are not only unique and valuable but also difficult for competitors to copy or subtitute?

The aim is to develop sustainable competitive advantage not competitive parity. Sustainable competitive advantage is possible only through performing different activities from rivals or performing similar activities in different ways. Companies such as difficult to imitate activity systems that have provided them with sustained competitive advantage. (Dess, Gregory G., G.T. Lumpkin and Marilyn L. Taylor. Strategic Management. 2nd edition. New York: McGraw-Hill Irwin, 2005.) As the father of strategic management, Dr. Igor Ansoff has put strategic management as a contingent theory (derived from adapted principle of requisite variety (Ansoff, 1984, p.5) which says that a single static set of prescriptions does not guarantee success but depends on the correct application of contingent methods that account for variations in the present & future complexity of the environment in which firms operate. (2nd generation planning) *Competitive advantages: An advantage that a firm has over its competitors, allowing it to generate greater sales or margins and/or retain more customers than its competition. There can be many types of competitive advantages including the firm's cost structure, product offerings, distribution network and customer support.

Corporate Finance Theory / Financial Management

Financial management also known as corporate finance or managerial finance, can be well explained through the explanation of duties performed by financial managers of a firm (it can be sole proprietor or partnership or a company) or through the scope of financial management. Money being the starting as well as end point of any organization for its functioning & survival financial management, i.e. acquiring funds & thus efficiently & wisely allocating them to various uses, is viewed as an integral part of overall management.

The three main financial decisions of a firm are: Investment, Financing & Dividend policy decisions (based on Marginal Analysis, risk return analysis).

Investment decision - this decision area includes selection of assets (long term as well as short term) in which funds should be invested. Broadly speaking, it includes capital budgeting & working capital decisions approach, net operating income approach, traditional approach, Modigliani approach, pecking order theory, signaling theory etc.

Return on investment:

$$ROI = \frac{Earnings - Initial\ Investment}{Initial\ Investment}$$

% Rate of change:

$$\%\Delta X = \frac{X_t - X_{t-1}}{X_{t-1}}$$

$\Delta X = change\ in\ X$
$t = at\ time\ t$

Capital Asset Pricing Model, CAPM

$$Expected\ Return = r_f + \boldsymbol{\beta}(r_m - r_f)$$

$r_f = risk\ free\ rate$
$\boldsymbol{\beta} = Beta$
$r_m = return\ on\ the\ market$

Capital Gain Yield

$$Capital\ Gains\ Yield = \frac{P_1 - P_0}{P_0}$$

$P_0 = Initial\ Stock\ Price$
$P_1 = Stock\ Price\ after\ 1st\ period$

Dividend decision – in relation to the determination of proportion of distributable profits to be distributed among shareholders as dividend or bonus & retained profits for growth investments.

Earnings per share

$$EPS = \frac{Net\ Income}{Weighted\ Avg\ Outstanding\ Shares}$$

Dividends per share

$$DPS = \frac{Dividends}{Number\ of\ Shares}$$

Strategic Management & Financial Management

Based on different paradigms FM assumes rational, optimal & efficient decision making & behavior on the basis of complete information availability. FM derives its principles from economics. SM is close to reality. It disregards the aforesaid assumption & recognizes uncertainty, volatility, dynamism, shocks & complexity in the real world. FM gives higher weightage to investors' satisfaction through maximization of the market price of the share & maximum returns over need for product market requirements. SM promotes an opportunism behavior wherein growth, building competitive advantages, improving product market performance is given higher importance. The approach towards risk varies. FM assumes financial risk i.e. variance between expected & actual returns & the possibility of bankruptcy.

$$Risk\ Premium = r_a - r_f$$

$r_a = asset\ or\ investment\ return$

$r_f = risk\ free\ return$

$$Real\ Rate\ of\ Return = \frac{1 + nominal\ rate}{1 + inflation\ rate} - 1$$

$$P/E\ Ratio = \frac{Price\ per\ Share}{Earnings\ per\ Share}$$

SM takes a different view of risk. Corporate strategic moves that cause returns to vary, that involve venturing into the unknown, and that may result in corporate ruin—moves for which the outcomes and probabilities may be only partially known and where hard-to-define goals may not be met. (Baird and Thomas, 1985:231–232).

Today's financial world is changing dramatically and this is reflected in the regional finance management practices in a rapid evolutionary curve driven by numerous environmental influences; one, a rapidly increasing organization scale, geographic scope of operations and business diversity, two, an emergence of financial markets with opportunities to access a wider set of innovative financing options with need of increased reporting and transparency, three, an increased merger and buyout activity driven by private equity and a need to enhance corporate valuations, and, four, an increasingly globalized competitive business environment with associated risks and uncertainties. The theories of finance were developed on the principles which did not consider the role & attitude of top management in decision making. There are some strategy variables which have a bearing on the behavior of management. The empirical work done till date has revealed significant relationship between strategy & financial variables. Extended work has been done in the areas like capital structure & product market performance in the light of dynamic environment, capital structure & output pricing, capital structure & product market interactions during the business cycle, strategic financial management of a conglomerate, impact of managerial motives on dividend decisions, influence of ownership on performance, optimal inventory policy for multiple products. Operations decisions making under multi brand competition, capital budgeting techniques & firm performance.

Conclusion

Accepting wealth maximization as an operationally useful criterion, financial management has assumed greater significance in the wake of increasing complexities in capital market, emergence of highly articulate & sophisticated money market, development of innovative financial instruments increasing participants in financial markets increasing boundaries of operations, foreign exchange management. Threat of mergers, acquisitions. Agency problems & organizational economics challenges Financial Management derived from macro-economics making best use of scarce resource of finance assumes optimal behavior on part of decision makers in the presence of complete information. This means, corporate finance as a branch of finance is based on certain assumptions related to the behavior of market & characteristics of the firm which when not satisfied leads to the redundancy of the model.