F3 | Chapter 1 | Finance Strategy

Corporate mission and strategy

For a business to succeed, its overall aims must be clearly stated and supported by focused objectives, which in turn are achieved through defined strategies.

One of those strategies will be the financial strategy.

Definition

Mission

The fundamental objective of an entity, expressed in general terms.

Example

Mission statements

"To embrace the human spirit and let it fly" - Virgin Atlantic.

"To be the Earth's most customer-centric company where people can find and discover anything they want to buy online" - Amazon.

The mission must be translated into objectives which should be clear, focused and specific. A company's strategy can be created from these objectives, many of which may have a financial focus.

Definition

Corporate strategy

A strategy is a course of action, including the specification of resources required, to achieve a specific objective.

The corporate strategy provides the direction for the business as a whole. It will include consideration of:

- Which markets and sectors should the business operate in?
- What are the core competencies of the business?
- How can we fund the business?
- How will the business gain competitive advantage?
- How will the business be structured?

In many businesses, each separate business unit will have their own strategy known as their business strategy.

Finance strategy

In order to achieve a corporate strategy, lower level strategies are needed. One of these strategies is the finance strategy.

Definition

Finance strategy

A course of action, including specification of financial resources required to achieve financial objectives.

Finance strategies focus on the financial elements of the overall corporate plan. This will include consideration of:

- Funding strategies
- Planning for financing of investments and fixed asset purchases
- Retaining liquidity
- How to retain financial control
- Financial risk management

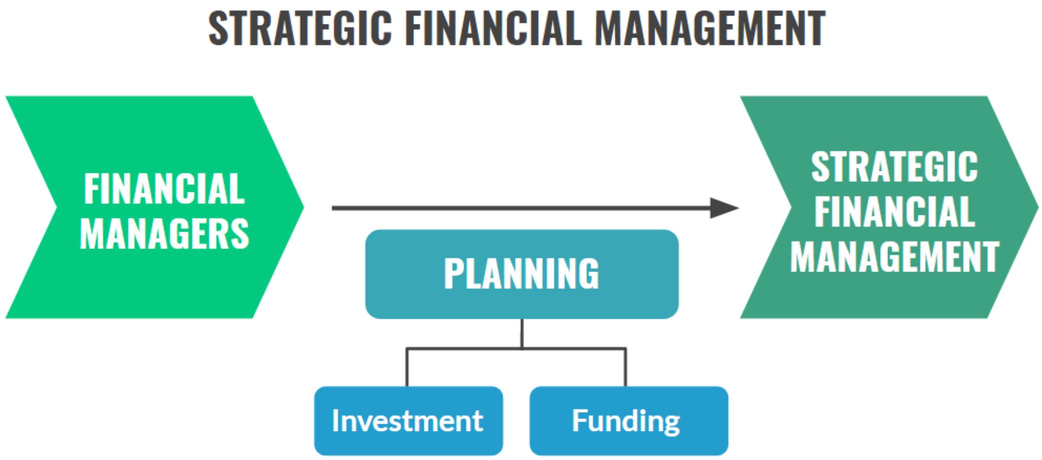
The overall financial objective of most profit making entities is to maximise shareholder wealth.

The process of developing a finance strategy

Financial decisions should be made as part of an overall strategic approach, flowing from the mission through to the corporate and business strategies.

The key decisions of financial strategy

A finance strategy requires planning and making decisions on investments, funding and payments. This planning is the core responsibility of strategic financial management as undertaken by financial managers.



Definition

Strategic financial management

The identification of the possible strategies capable of maximising an entity's net present value, the allocation of scarce capital resources among the competing opportunities and the implementation and monitoring of the chosen strategy to achieve stated objectives.

Breaking this down into the different elements we have:

- **Identifying strategies** – identifying possible strategic projects an organisation can take
- **Maximising an entity's net present value** – designed to ensure the strategy aims to maximise shareholder wealth
- **Allocation of resources** – capital resources are limited and this requires the selection of projects that will maximise NPV
- **Monitoring the chosen strategy –** evaluating whether projects will work out as expected, including making appropriate adjustments and changes

The three decisions of strategic financial management

Strategic financial management can be achieved by making decisions based on three key decisions: investment, financing and dividends.

Investment decisions

Concerned with how limited funds are allocated to projects. A key part of the financial manager's role is to understand the short, medium and long term capital requirements for investment that fits the overall strategy.

Financing decisions

Concern the acquisition of appropriate finance to suitably meet the financial objectives of the company. Decisions are based on:

- **Level of internal funding –** e.g. from business operations, a more profitable company is able to finance itself more frequently
- **Long-term capital structure –** is external funding sourced via debt or equity?
- **Working capital required** – how much funding is required to pay debts as they fall due? This can be from long-term finance or short-term credit such as overdrafts

Dividend decisions

Decisions based around a business's approach to rewarding shareholders.

How much should be paid out of retained earnings to shareholders and how much should be retained in the business in order to grow?

The three financial decisions are interrelated:

- **Investment and raising funds –** an entity cannot make a decision to invest without considering how the funds will be raised
- **Dividends and shareholders –** investors will want higher dividends for investing in riskier projects

- **Financing and dividends –** raising equity finance will require greater future dividends to be paid out

Stakeholders and the three financial decisions

The three financial decisions have an important and direct relationship on stakeholders.

Investment decision impacts	
Shareholders	Shareholders will demand that investments have a positive NPV.
Employees	Better job security or potential promotions if an entity is investing for growth. But mergers and acquisitions could mean job losses.
Banks	Opportunities to lend to support the project. However, they will want to ensure the business can repay the debt.
Suppliers	New opportunities to supply the company.

Finance decisions concern how funding is utilised. This can impact different types of stakeholders:

- **Shareholders** – financial risk from debt finance, while compulsory interest may impact the regularity of dividends
- **Employees** – financial risk from debt finance could result in job losses or corporate collapse
- **Banks –** financial risk from debt finance may result in late or failed interest payments. Debt covenants may restrict new lending, while lender ratios may not be met, with banks asking for loans to be paid back
- **Suppliers** – harsher payment terms may be imposed by suppliers if there is higher debt and so greater risk to them of non-payment.

Dividend decision impacts	
Shareholder	The level and frequency of dividends paid will determine if shareholder needs are met
Employees	More dividend payments means less funds available for pay increases or bonuses
Banks	Terms of loans may be breached by dividend payments e.g. if it reduces the assets below an agreed threshold
Suppliers	Supplier payments may be impacted by payment of dividends

Example

Company X are financing a new project (30% equity and 70% debt) which is the first task of this nature for the company. A large profit is forecast after completion in five years.

The interrelationships of decision are as follows:

Investment – profitable but risky project requiring a large amount of external finance.

Funding – a long term loan is required as returns will not be generated for some years to come. Risky project means a higher interest rate will be charged on this loan.

Dividend – shareholders must be compensated for investing in a high risk project and the financial risk incurred by the funding.

Impact of the investment, finance and dividend decisions on stakeholders:

Shareholders – the profit from the investment will increase shareholder wealth, but there will be concerns about the risks from the debt funding.

Banks – they will require security for the loan. They may also prevent the company from taking out any additional debt until they have been repaid.

Employees – job security for those involved in the project. Concerns about bonuses and the company collapsing due to high interest payments may be prevalent.

And finally...

Stop!

By this stage you should know:

- What missions, objectives, corporate strategies and finance strategies are
- The three key decisions of financial strategy
- The interrelationships between the three decisions
- How stakeholders are impacted by these decisions

Got it?

If not, go back and re-read the study text before moving on.

Question Time

It's now time to practise questions.

If **you've signed up** for our practice questions or are on our fully inclusive course, here's a direct link to questions for this chapter:

Go to Practice Questions

If **you want to sign up** for our practise questions here's where you will find more details:

Sign Up for Questions