

Strategic Financial Management: A Review

Shruti Gupta

Assistant Professor, Zakir Husain Delhi College, University of Delhi, New Delhi, INDIA

ABSTRACT

Strategic financial management (SFM) integrates the financial management function into the corporate strategy. It aims at creating value through finance by supporting the overall strategy of the company. Thus, SFM is the portfolio constituent of the corporate strategic plan that embraces the optimum investment and financing decisions required to achieve the overall objectives in the face of intense competition. In other words, it is the combination of financing and investment policies of the firm so that the shareholders' wealth is maximised, to whom the management is ultimately responsible. An attempt has been made in this paper to understand the concept of SFM by reviewing the existing literature.

Keywords-- Strategic Financial Management, Capital Expenditure, Capital Structure, Working Capital

I. INTRODUCTION

The financial performance of a corporate business firm is often influenced by the sound financial management policies, decisions and practices. It is very important for the business enterprises in view of the present dynamic environment, economic scenario of liberalisation and globalisation causing intense competition and less profit margins.

Moreover, increased pressures of globalisation, severe competition and general slow down in the global economies have forced the business enterprises to rethink their strategic positions. To remain profitable and retain competitive advantage, companies learnt the need to focus their energies on core competence both in terms of time and resources. Studies have been made in the past in both developed and developing countries to find out the financial management practices followed by the business enterprises. This paper seeks to review the major studies in the areas of capital expenditure, capital structure, working capital, dividend decision.

A study was carried out by Butt, Hunjra and Rehman (2010) to measure the relationship between organisational performance and financial management practices in Pakistani corporate sector. It was found that all financial management practices have a positive and significant impact on organisational performance. However, financial managers perceive financial performance assessment, working capital policy and capital structure decision more important than dividend policy and investment appraisal techniques. An attempt has been made by Correia and Cramer (2008) to find

out and analyse the corporate finance practices of South African listed companies in relation to cost of capital, capital structure and capital budgeting decisions. The results of the survey were mostly in line with the financial theory. Jain and Yadav (2005) made a modest attempt to study the financial management practices followed in respect of capital budgeting, capital structure, dividend policies, working capital decision and risk management practices by the central PSEs in India. As far as financing pattern of long-term investment projects were concerned, service PSEs were following sound financing policies as their fixed assets have been financed from long-term sources. However, short-term debt has been used to finance long-term investments in case of manufacturing PSEs. Another notable finding was that the most popular method used by the sample PSEs in evaluating their capital budgeting proposals is IRR followed by Pay Back Period (PBP) and Average Rate of Return (ARR). However, it was gratifying to note that the vast majority of the sample PSEs were using a combination of traditional and discounted cash flow (DCF) techniques. Furthermore, vast majority of the sample PSEs in India have stated their marked preference not only for paying dividends in the changing scenario of economic liberalisation and globalisation but also to pursue stable dividend policy.

A similar effort has been made by Anand (2002) in the study of corporate finance practices in India with a special focus on capital budgeting, cost of capital, capital structure and dividend policy. The Mann-Whitney U test has been used to test whether responses differ across firm size, profitability, risk, growth, CFO's education and sector. The analysis revealed that the practitioners do use the basic corporate finance tools like NPV, CAPM and pecking order theory for capital budgeting, cost of capital and capital structure decisions to a great extent. However, the corporate finance practices vary with the firm size. The study carried out by Nguyen (2001) investigates financial management practices and financial characteristics of SMEs in Vietnam and then, examined the impact of financial management practices and financial characteristics on SME profitability. It was revealed that the current ratio has negatively affected the SME profitability. On the contrary, total asset turnover, working capital management and short-term planning practices, fixed asset management and long-term planning practices, financial and accounting information system has positively affected the SME profitability. Graham and Harvey (2001) conducted a comprehensive study that

analysed the practices of corporate finance with particular focus on areas of capital budgeting and capital structure. With respect to capital budgeting, it revealed that most companies follow academic theory and use discounted cash flow (DCF) and Net Present Value (NPV) techniques to evaluate new projects. But when it comes to making capital structure decisions, corporations appeared to pay less attention to finance theory and rely instead on practical, informal rules of thumb. The relation between the executives' responses and various company characteristics such as size, P/E ratio, leverage, credit rating, dividend policy and industry was also examined in the study which showed that firm size had significantly affected the practice of corporate finance.

Capital expenditure being an important part of financial decision has extensively been reviewed in this paper. *Brunzell, Lilojebloom and Vaihekoshi (2011)*, using survey data for 157 Nordic firms studied the determinants for the choice of capital budgeting methods and setting of hurdle rates (WACC) in five Nordic countries. It was found that the use of NPV method was most popular and the sophistication of capital budgeting was related both to firm characteristics as well as to CFO characteristics. When studying the determinants for the choice of NPV as a primary method, support for variables relating to real options was there. They also found support for influences from CFO characteristics that is NPV was significantly less often used in firms where CFO is older than 50 years. As far as setting of hurdle rate was concerned, a significant positive hurdle rate premium was found. *Hall and Millard (2010)* also investigated the application of capital budgeting techniques and the incorporation of risk into the capital budgeting process among South African industrial firms which indicated that the NPV was just as popular as the IRR and risk was incorporated more often into evaluating capital budgeting projects. Furthermore, sensitivity analysis was the most popular method for the risk analysis. A study conducted by *Ryan and Ryan (2002)* on fortune 1000 US companies found that management views NPV as the most preferred capital budgeting tool followed by IRR. Additionally, firms with larger capital budgets tend to favour NPV and IRR.

Whereas *Shinoda (2010)* in its study found that Japanese management preferred the PBP as a capital budgeting tool. At the same time, however, the number of Japanese companies using NPV and IRR has gradually increased. It was also discovered that Japanese firms manage their decision-making by a combination of PBP and NPV method. A similar analysis was made by *Abdullah and Nordin (2005)* that reported the prevalent use of the PBP and the ARR techniques in evaluating the capital investment projects which was followed by NPV and IRR methods. *Liljebloom and Vaihekoski (2004)* conducted a survey among the publicly listed Finnish companies in order to investigate the practices of investment evaluation methods, their use, and the required rate of return. It was revealed that even though NPV was gaining more popularity, the PBP method was still most often used as the primary method by Finnish companies.

Alkaraan and Northcott (2006) however examined the use of both conventional financial analysis tools and selected emergent analysis approaches in the capital investment decision-making of large UK manufacturing companies. It was found that the use of all financial analysis techniques has increased with time, with the greatest use of DCF analysis techniques and universal use of multiple techniques depending on the project. Moreover, *Brealey and Myers (2000)* observed that a few large organisations used PBP or ARR as their primary method of project choice. Most of the firms used discounted cash flow (DCF) methods and for many DCF means IRR and not NPV. The reason might be that IRR was easier to be explained to non-financial managers.

Factors affecting capital structure has been discussed in the study carried by *Sheikh and Wang (2011)* in Pakistan. The results suggested that profitability, liquidity, earnings volatility and tangibility were related negatively to the debt ratio, whereas firm size was positively linked to the debt ratio. Moreover, non-debt tax shields and growth opportunities do not appear to be significantly related to the debt ratio. The findings were consistent with the predictions of the trade-off theory, pecking order theory, and agency theory which showed that capital structure models derived from Western settings do provide some help in understanding the financing behaviour of firms in Pakistan. A similar analysis was made by *Eriotis, Vasiliou and Ventoura (2007)* to study the firm characteristics that affect the capital structure. The results showed that size of the firm had a positive relation with the debt ratio and the liquidity of the firm is negatively related to its financial leverage. *Mohanty (2000)* conducted a study of Indian companies with regard to their capital structure decisions. It was reported that leverage was negatively related with profitability and value of the firm both within an industry as well as within the Indian economy. *Karadeviz, et al. (2009)* investigated the factors that affect the capital structure decisions of the lodging companies listed on Istanbul Stock Exchange. Although the findings partially supported the pecking order theory, neither the trade-off theory nor the pecking order theory fully explained the capital structures of Turkish lodging companies.

Bancel and Mittoo (2001) surveyed the managers of firms in sixteen European countries to examine the link between theory and practice of capital structure. The evidence showed that financial flexibility and the earnings per share dilution were the most important determinants of the capital structure decisions of the European managers. It was found that there was a modest support for the trade-off theory but weak support for the pecking order theory or agency theory framework. Similar to earlier studies, *Huang and Song (2006)* carried out a study on 1200 Chinese listed companies to document their capital structure characteristics. As in other countries, leverage in Chinese firm increases with firm size and decreases with profitability and managerial shareholdings. *Jain and Yadav (2000)* conducted a study to compare the current assets management practices of corporates in India, Singapore and Thailand. It was found that bank overdraft/cash credit is the major source of dealing with

cash deficit situations. Also, Indian firms followed the practice of deploying excess cash primarily by investing in short-term marketable securities, retiring short-term debt and making deposits with bank for short period. As far as company's policy towards financing WC was concerned, 'matching approach' seems to be predominant among Indian corporates and 'aggressive approach' seems to be more popular with Thai firms as well as Singapore corporates. An attempt has also been made by *Jain and Kumar (1999)* where it was found that accounts payable and short term loans were the two major ingredients of total current liabilities. Furthermore, suppliers offered cash discount facility for prompt payment. Majority of the sample companies had experienced occasional shortage as well as surplus of working capital.

Dividend decision has also been reviewed in this paper. *Ghosh (2010)* conducted a study to investigate the dividend policy of a sample of Indian firms. The results suggested that bigger and established firms tend to pay more dividends. Also dividends were significantly and negatively related to leverage, that is, high debt was an important constraining factor for firms in paying dividends. A modest attempt has been made by *Gupta and Banga (2010)* to examine the determinants to corporate dividend decision of Indian companies. Five broad factors viz., leverage, liquidity, profitability, ownership structure and growth were considered which showed that these gave expected signs except profitability that did not revealed the expected sign. An attempt has been made by *Jayesh (2006)* to investigate the association between the corporate governance and the dividends payout for a panel of Indian firms over the period 1994-2000. It was found that there was a positive association between dividends with earnings trend and investment opportunities. Debt equity ratio was found to be negatively associated whereas past investment opportunities exert a positive impact on dividends. A similar attempt has been made by *Singhania (2005)* to investigate the trends in dividend payout of select Indian companies. It was found that the sample companies, which declared dividend in any given year, declined over the period of study from 448 companies in 1992 to 376 companies in 2004. However, the average dividend payout ratio increased significantly along with showing a volatile trend ranging from about 25-68 percent during 1992-2004. Furthermore, wide industry-wise fluctuations were visible and a major proportion of the sample companies followed a dividend policy of part retention and part distribution of profits.

Brav, Graham, Harvey and Michaely (2005) made a study to determine the factors that drive dividend and share repurchase decisions. The findings indicated that maintaining the dividend level was on par with investment decisions, while repurchases were made out of the residual cash flow after investment spending. Perceived stability of future earnings affected the dividend policy. However, it was found that the link between dividends and earnings had weakened. Many managers though favour repurchases because they were viewed as being more flexible than dividends and could be used in an attempt to time the equity market or to increase earnings per share. However, executives

believed that institutions were indifferent between dividends and repurchases and that payout policies had little impact on their investor clientele. Tax considerations play a secondary role. *Baker, Veit and Powell (2001)* made a comprehensive study to identify the most important factors in making dividend policy decisions. The most important determinants of dividend decision that appeared to be are: the pattern of past dividends, stability of earnings and the level of current and expected future earnings. However, it was also revealed that no universal set of factors was likely to be applicable to all firms because various market frictions or imperfections might affect firms in different ways.

II. CONCLUSION

The studies made upto now are significant and have made some contribution to the existing knowledge about financial management practices. However, these research works suffers from some limitations. Only a handful of studies have been carried out to cover all its decisions namely, capital budgeting, capital structure, working capital management and dividend decision. The available research works are undoubtedly important but these are not comprehensive as most of the researchers conducted in India or abroad considers either of these decisions. An attempt could be made further to overcome some of the limitations of the existing works that would bridge this gap.

REFERENCES

- [1] Abdullah, N.A. and Nordin, S. (2008), "The Theory-Practice Gap of Project Appraisals", *Journal Pengurusan*, Vol. 27, pp. 85-104.
- [2] Alkaraan, F. and Northcott, D. (2006), "Strategic capital investment decision-making : A role for emergent analysis tools" A Study of practice in large UK manufacturing Companies", *The British Accounting Review*, Vol. 38, No. 2, pp. 149-173.
- [3] Anand, Manoj (2002), "*Corporate Finance Practices in India : A Survey*", Vikalpa, Vol. 27, No. 4, Oct-Dec., pp. 29-56.
- [4] Baker, H.K., Veit, E.T. and Powell, G.E. (2001), "Factors influencing Dividend Policy Decisions of Nasdaq Firms", *The Financial Review*, Vol. 38, pp. 19-38.
- [5] Bancel, F. and Mittoo, U.R. (2001), "The Determinants of Capital Structure Choice : A Survey of European Firms", <http://ssrn.com/abstract=299172>
- [6] Brav, A., Graham, J.R., Harvey, C.R. and Michaely, R. (2005), "Payout policy in the 21st century", *Journal of Financial Economics*, Vo. 77, No. 3, pp. 483-527.
- [7] Brealey R.A. and Myers, S.C. (2000), *Principial of Corporate Finance*, New Delhi: Tata McGraw Hill.
- [8] Brunzell, T., Liljebloom, E. and Vaihekoski, M. (2011), "Determinants of capital budgeting methods and hurdle rates in Nordic firms", *Accounting and Finance*, Vol. 51, No. 4, pp. 1-26.
- [9] Butt, B.Z., Hunjra, A.I. and Rehman, K. (2010), "Financial Management Practices and Their Impact on

Organisational Performance”, *World Applied Sciences Journal*, Vol. 9, No. 9, pp. 997-1002.

[10] Correia, C. and Cramer, P. (2008), “An analysis of cost of capital, capital structure and capital budgeting practices: a survey of South African listed companies”, *Mediterranean Accounting Research*, Vol. 16, No. 2, pp. 31-52.

[11] Eriotis, N., Vasiliou, D. and Ventoura-Neokosmidi, Z. (2007), “How firm characteristics affect capital structure: an empirical study”, *Managerial Finance*, Vol. 33, No. 5, pp. 321-331.

[12] Ghosh, Saibal (2010), “The dividend strategy of Indian companies: An empirical assessment”, <http://mpira.ub.uni-muenchen.de/29567>

[13] Graham, J.R. and Harvey, C.R. (2001), “The theory and practice of corporate finance: Evidence from the field”, *Journal of Financial Economics*, Vol. 60, Nos. 2 & 3, pp. 187-243.

[14] Gupta A. and Banga, C. (2010), “The Determinants of Corporate Dividend Policy”, *Decision*, Vol. 37, No. 2, pp. 63-77.

[15] Hall, J. and Millard, S. (2010), “Capital Budgeting Practices used by selected listed South African firms”, *South African Journal of Economics and Management Science*, Vol. 13, No. 1, pp. 85-97.

[16] Jain, P.K. and Kumar, Manoj (1999), “Current Liability Management Practices in Select Corporate Firms of India and Southeast Asia : A Comparative Study”, *Business Analysts*, Jan-June, pp. 1-13.

[17] Jain, P.K. and Yadav, S.S., (2000), “Current Assets Management : A Comparative Study of India, Singapore and Thailand”, *Vision : The Journal of Business Perspective*, July – December, pp. 5-19.

[18] Jain, P.K., Yadav, S.S. (2005), *Financial Management Practices: A Study of Public Sector Enterprises in India*, New Delhi: Hindustan Publishing Corporation (India).

[19] Jayesh, K. (2006), “Corporate Governance and Dividends Payout in India”, *Journal of Emerging Market Finance*, Vol. 5, No. 1, pp. 15-58.

[20] Karadeviz, E., Kandir, S.Y., Balcilar, M. and Onal, Y.B. (2009), “Determinants of capital structure: evidence from Turkish lodging companies”, *International Journal of Contemporary Hospitality Management*, Vol. 21, No. 5, pp. 594-609.

[21] Liljeblom, E. and Vaihekoski, M. (2004), “Investment Evaluation Methods and Required Rate of Return in Finnish Publicly Listed Companies”, *Finnish Journal of Business Economics*, Vol. 1, pp. 9-24.

[22] Mohanty, Pitabas (2000), “Information asymmetry and the capital structure : An empirical investigation into the capital structure of Indian companies”, *ICFAI Journal of Applied Finance*, Vol. 6, No. 1, pp. 24-39.

[23] Nguyen, Kieu Minch (2001), *“Financial Management and Profitability of Small and Medium Enterprises”*. Australia: Southern Cross University, N.S.W.

[24] Ryan, P.A. and Ryan, G.P. (2002), “Capital Budgeting Practices of the Fortune 1000: How have things changed?”, *Journal of Business and Management*, Vol. 8, No. 4, Winter, pp. 355-364.

[25] Sheikh, N.A., Wang, Z. (2011), “Determinants of Capital Structure: An empirical study of firms in Manufacturing industry of Pakistan,” *Managerial Finance*, Vol. 37, Issue 2, pp. 117-133.

[26] Shinoda, Tomonari (2010), “Capital Budgeting Management Practices in Japan – A Focus on the use of Capital Budgeting Methods”, *Eco. J. of Hokkaido Univ.*, Vol. 39, pp. 39-50.

[27] Singhania, Monica (2005), “Trends in Dividend Payout : A Study of Select Indian Companies”, *Journal of Management Research*, Vol. 5, No. 3, pp. 129-142.