Graziadio Business Review | Graziadio School of Business and Management | Pepperdine University

The Role of Finance in the Strategic-Planning and Decision-Making Process

Financial Goals and Metrics Help Firms Implement Strategy and Track Success

By Pedro M. Kono, DBA and Barry Barnes, PhD

2010 Volume 13 Issue 1

The fundamental success of a strategy depends on three critical factors: a firm's alignment with the external environment, a realistic internal view of its core competencies and sustainable competitive advantages, and careful implementation and monitoring.[1] This article discusses the role of finance in strategic planning, decision making, formulation, implementation, and monitoring.

[powerpress: http://gsbm-med.pepperdine.edu/gbr/audio/winter2010/PedroKono_article.mp3]

Any person, corporation, or nation should know who or where they are, where they want to be, and how to get there.[2] The strategic-planning process utilizes analytical models that provide a realistic picture of the individual, corporation, or nation at its "consciously incompetent" level, creating the necessary motivation for the development of a strategic plan.[3] The process requires five distinct steps outlined below and the selected strategy must be sufficiently robust to enable the firm to perform activities differently from its rivals or to perform similar activities in a more efficient manner.[4]

A good strategic plan includes metrics that translate the vision and mission into specific end points.[5] This is critical because strategic planning is ultimately about resource allocation and would not be relevant if resources were unlimited. This article aims to explain how finance, financial goals, and financial performance can play a more integral role in the strategic planning and decision-making process, particularly in the implementation and monitoring stage.

The Strategic-Planning and Decision-Making Process

1. Vision Statement

The creation of a broad statement about the company's values, purpose, and future direction is the first step in the strategic-planning process.[6] The vision statement must express the company's core ideologies—what it stands for and why it exists—and its vision for the future, that is, what it aspires

to be, achieve, or create.[7]

2. Mission Statement

An effective mission statement conveys eight key components about the firm: target customers and markets; main products and services; geographic domain; core technologies; commitment to survival, growth, and profitability; philosophy; self-concept; and desired public image.[8] The finance component is represented by the company's commitment to survival, growth, and profitability.[9] The company's long-term financial goals represent its commitment to a strategy that is innovative, updated, unique, value-driven, and superior to those of competitors.[10]

3. Analysis

This third step is an analysis of the firm's business trends, external opportunities, internal resources, and core competencies. For external analysis, firms often utilize Porter's five forces model of industry competition,[11] which identifies the company's level of rivalry with existing competitors, the threat of substitute products, the potential for new entrants, the bargaining power of suppliers, and the bargaining power of customers.[12]

For internal analysis, companies can apply the industry evolution model, which identifies takeoff (technology, product quality, and product performance features), rapid growth (driving costs down and pursuing product innovation), early maturity and slowing growth (cost reduction, value services, and aggressive tactics to maintain or gain market share), market saturation (elimination of marginal products and continuous improvement of value-chain activities), and stagnation or decline (redirection to fastest-growing market segments and efforts to be a low-cost industry leader).[13]

Another method, value-chain analysis clarifies a firm's value-creation process based on its primary and secondary activities.[14] This becomes a more insightful analytical tool when used in conjunction with activity-based costing and benchmarking tools that help the firm determine its major costs, resource strengths, and competencies, as well as identify areas where productivity can be improved and where re-engineering may produce a greater economic impact.[15]

SWOT (strengths, weaknesses, opportunities, and threats) is a classic model of internal and external analysis providing management information to set priorities and fully utilize the firm's competencies and capabilities to exploit external opportunities,[16] determine the critical weaknesses that need to be corrected, and counter existing threats.[17]

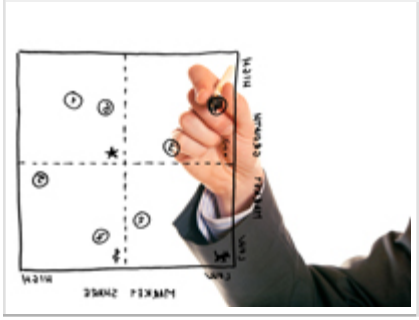
4. Strategy Formulation

To formulate a long-term strategy, Porter's generic strategies model [18] is useful as it helps the firm aim for one of the following competitive advantages: a) low-cost leadership (product is a commodity, buyers are price-sensitive, and there are few opportunities for differentiation); b) differentiation (buyers' needs and preferences are diverse and there are opportunities for product differentiation); c) best-cost provider (buyers expect superior value at a lower price); d) focused low-cost (market niches with specific tastes and needs); or e) focused differentiation (market niches with unique preferences and needs).[19]

5. Strategy Implementation and Management

In the last ten years, the balanced scorecard (BSC)[20] has become one of the most effective management instruments for implementing and monitoring strategy execution as it helps to align strategy with expected performance and it stresses the importance of establishing financial goals for employees, functional areas, and business units. The BSC ensures that the strategy is translated into objectives, operational actions, and financial goals and focuses on four key dimensions: financial factors, employee learning and growth, customer satisfaction, and internal business processes.[21]

The Role of Finance



Financial metrics have long been the standard for assessing a firm's performance. The BSC supports the role of finance in establishing and monitoring specific and measurable financial strategic goals on a coordinated, integrated basis, thus enabling the firm to operate efficiently and effectively. Financial goals and metrics are established based on benchmarking the "best-in-industry" and include:

1. Free Cash Flow

This is a measure of the firm's financial soundness and shows how efficiently its financial resources are being utilized to generate additional cash for future investments.[22] It represents the net cash available after deducting the investments and working capital increases from the firm's operating cash flow. Companies should utilize this metric when they anticipate substantial capital expenditures in the near future or follow-through for implemented projects.

2. Economic Value-Added

This is the bottom-line contribution on a risk-adjusted basis and helps management to make effective, timely decisions to expand businesses that increase the firm's economic value and to implement corrective actions in those that are destroying its value.[23] It is determined by deducting the operating capital cost from the net income. Companies set economic value-added goals to effectively assess their businesses' value contributions and improve the resource allocation process.

3. Asset Management

This calls for the efficient management of current assets (cash, receivables, inventory) and current liabilities (payables, accruals) turnovers and the enhanced management of its working capital and cash conversion cycle. Companies must utilize this practice when their operating performance falls behind industry benchmarks or benchmarked companies.

4. Financing Decisions and Capital Structure

Here, financing is limited to the optimal capital structure (debt ratio or leverage), which is the level that minimizes the firm's cost of capital. This optimal capital structure determines the firm's reserve borrowing capacity (short- and long-term) and the risk of potential financial distress.[24] Companies

establish this structure when their cost of capital rises above that of direct competitors and there is a lack of new investments.

5. Profitability Ratios

This is a measure of the operational efficiency of a firm. Profitability ratios also indicate inefficient areas that require corrective actions by management; they measure profit relationships with sales, total assets, and net worth. Companies must set profitability ratio goals when they need to operate more effectively and pursue improvements in their value-chain activities.

6. Growth Indices

Growth indices evaluate sales and market share growth and determine the acceptable trade-off of growth with respect to reductions in cash flows, profit margins, and returns on investment. Growth usually drains cash and reserve borrowing funds, and sometimes, aggressive asset management is required to ensure sufficient cash and limited borrowing.[25] Companies must set growth index goals when growth rates have lagged behind the industry norms or when they have high operating leverage.

7. Risk Assessment and Management

A firm must address its key uncertainties by identifying, measuring, and controlling its existing risks in corporate governance and regulatory compliance, the likelihood of their occurrence, and their economic impact. Then, a process must be implemented to mitigate the causes and effects of those risks.[26] Companies must make these assessments when they anticipate greater uncertainty in their business or when there is a need to enhance their risk culture.

8. Tax Optimization

Many functional areas and business units need to manage the level of tax liability undertaken in conducting business and to understand that mitigating risk also reduces expected taxes.[27] Moreover, new initiatives, acquisitions, and product development projects must be weighed against their tax implications and net after-tax contribution to the firm's value. In general, performance must, whenever possible, be measured on an after-tax basis. Global companies must adopt this measure when operating in different tax environments, where they are able to take advantage of inconsistencies in tax regulations.

Conclusion

The introduction of the balanced scorecard emphasized financial performance as one of the key indicators of a firm's success and helped to link strategic goals to performance and provide timely, useful information to facilitate strategic and operational control decisions. This has led to the role of finance in the strategic planning process becoming more relevant than ever.

Empirical studies have shown that a vast majority of corporate strategies fail during execution. The above financial metrics help firms implement and monitor their strategies with specific, industry-related, and measurable financial goals, strengthening the organization's capabilities with hard-to-imitate and non-substitutable competencies. They create sustainable competitive advantages that

maximize a firm's value, the main objective of all stakeholders.

[1] M.E. Porter, "What is Strategy?" *Harvard Business Review*, 74, no. 6 (1996). [purchase required]

[2] D. Abell, *Defining the Business: The Starting Point of Strategic Planning*, (New Jersey: Prentice-Hall, 1980).

[3] J.S. Bruner, *The Process of Education: A Landmark in Education Theory*, (hyperlink no longer accessible). (Boston: Harvard University Press, 1977).

[4] J.A. Pearce and R.B. Robinson, *Formulation, Implementation, and Control of Competitive Strategy*, (New York: Irwin McGraw-Hill, 2000).

[5] C.S. Clark and S.E. Krentz, "Avoiding the Pitfalls of Strategic Planning," *Healthcare Financial Management*, 60, no. 11 (2004): 63–68.

[6] T. Jick and M. Peiperl, *Managing Change: Cases and Concepts*, (New York: Irwin/McGraw-Hill, 2003).

[7] J.C. Collins and J.I. Porras, "Building Your Company's Vision," *Harvard Business Review*, 74, no. 5 (1996). [purchase required]

[8] Pearce and Robinson.

[9] J.A. Pearce and F. David, "Corporate Mission Statement: The Bottom Line," *The Academy of Management Executive*, 1, no. 2 (1987): 109–116. [purchase required]

[10] R.K. Johnson, "Strategy, Success, a Dynamic Economy, and the 21st Century Manager," *The Business Review*, 5, no. 2 (2006).

[11] M.E. Porter, "How Competitive Forces Shape Strategy," *Harvard Business Review*, 57, no. 2 (1979).

[12] Ibid.

[13] A.A. Thompson, A.J. Strickland, and J.E. Gamble, *Crafting and Executing Strategy*, (New York: McGraw-Hill/Irwin, 2009).

[14] Pearce and Robinson.

[15] Thompson, Strickland, and Gamble.

[16] B. Jovanovic and G.M. MacDonald, "The Life Cycle of a Competitive Industry," *The Journal of Political Economy*, 102, no. 2 (1994: 322–347).

[17] C.A. Lai and J.C. Rivera, Jr., "Using a Strategic Planning Tool as a Framework for Case Analysis," *Journal of College Science Teaching*, *36*, no. 2 (2006): 26–31.

[18] M.E. Porter, *Competitive Advantage: Techniques for Analyzing Industries and Competitors*, (New York: The Free Press, 1980).

[19] Thompson, Strickland, and Gamble.

[20] R.S. Kaplan and D.P. Norton, "Using the Balanced Scorecard as a Strategic Management System," (hyperlink no longer accessible). *Harvard Business Review*, 74, no. 1 (1996).

[21] Ibid.

[22] Peter Grant, "How Financial Targets Determine Your Strategy," *Global Finance*, 11, no. 3 (1997): 30–34

[23] Ibid.

[24] Sidney L. Barton and Paul J. Gordon, "Corporate Strategy: Useful Perspective for the Study of Capital Structure?" *The Academy of Management Review*, 12, no. 1 (1987): 67–75.

[25] B.T. Gale and B. Branch, "Cash Flow Analysis: More Important Than Ever," *Harvard Business Review*, July–August (1981).

[26] H.D. Pforsich, B.K.P. Kramer, and G.R. Just, "Establishing an Effective Internal Audit Department," *Strategic Finance*, 87, no. 10 (2006): 22–29.

[27] Q. Lawrence, "Hedging in Perspective," *Corporate Finance*, 115, no. 36 (1994).

About the Author(s)

Pedro M. Kono, DBA, is a professor of finance at Graziadio School of Business and Management at Pepperdine University and Fox School of Business at Temple University. He is also the president of Key Financing Solutions, a company engaged in structuring vendor programs and international financing. Dr. Kono worked for many years for Citigroup in the U.S., U.K., Japan, and Brazil, and gained significant international and diversified management experience at commercial banking, leasing, and finance companies. He obtained his doctoral degree from Wayne Huizenga School of Business and Entrepreneurship at Nova Southeastern University and has conducted research in the fields of corporate finance, specifically in the investment area, and corporate strategy. He is currently researching the market efficiency hypothesis and the performance of Exchange-Traded Funds (ETFs) in the U.S., Japan, and Brazil.

Barry Barnes, PhD, is the Chair of Leadership at Nova Southeastern University in Fort Lauderdale, Florida, where he teaches graduate-level courses in leadership, strategic decision making, and organizational behavior. In 2009, he received an Outstanding Research Award at the Global Conference on Business and Finance; he received a Best Paper Award at the International Global Academy of Business, and he was selected as Faculty Member of the Year in 2000. Dr. Barnes has

published in the International Journal of Organizational Analysis, The International Journal of Business Research, Review of Business Research, the Journal of Applied Management and Entrepreneurship, and other journals. His recent research and writing focus on the relationship between leadership, organizational change, and strategy, as well as the innovative and improvisational business practices of the legendary rock band the Grateful Dead.

Issue: 2010 Volume 13 Issue 1
Topic: Finance / Investing / Accounting
Tags: asset management, decision analysis, finance, free cash flow, strategic planning

---

Comments

It is a excellent idea for company growth. Internal audit and good governance and control processes is vital support for financial planning and decision bench marking.

Trackbacks

1. The Role of Finance in The Strategic Planning & Decision Making Process | Corporate CFO