FINANCIAL INDICATORS OF BUSINESS MARKETS

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Abstract: *This article provides a financial indicators of business markets and the methods in the transition to international financial reporting standards and ways to overcome them.*

Keywords: *business, strategic resilience, costs, debts, investment.*

Business organizations exist within the context of larger market economies where conditions are always changing. By advocating a *strategic resilience,* which is achievable when managers anticipate and adjust to changes that threaten a company's core competencies. However, our suggestions for developing strategic resilience contain little guidance for incorporating financial decisions in the organization's strategic deliberations. Despite this omission, financial decision making is an important part of the process of making a business more resilient. In early 2021, a survey of 1,054 senior financial executives reported that 41 percent had an increase in their responsibilities related to strategy business development in the past 18 months. Other areas with significant increases included information technology, customer service, risk analysis, operations, and human resources. Such expansion in responsibilities of these finance specialists attests to the importance of considering financial elements in developing business resilience. This article outlines recommendations for doing so through a systematic approach to financial decisions that can positively impact strategic resilience.

An initial step for financial analysis is the quantitative evaluation of a firm's investment opportunities. But special care is required here. The traditional Net Present Value (NPV) computations, first made popular by Dean, assume that once an investment is made, a manager cannot revise the initial commitment of resources in order to change future cash flows. These methods are still taught today, but they ignore flexibility. Many investments are not passive investments that are unchangeable once committed. Managers can and do act after initial investment commitments have been made to adjust the size and nature of cash

flows when past assumptions about future conditions prove incorrect. To reflect the market value of such potential adjustments, Real Option Theory moves away from NPV's assumption of a passive manager who no longer acts once an investment decision is made, to that of active management that permits managers to enact changes in resource commitments after initial investment is made. In this new view, total NPV of an investment opportunity is seen as a sum of two components: 1. The NPV with no revisions, plus 2. The NPV that is associated with possible revisions in commitments.

Real Option Theory offers financial assessment of the flexibility that facilitates a company's strategic resilience capabilities. It provides a method to quantify the value of managerial flexibility so that a manager's real options can become part of NPV analyses. This approach can be used for several different purposes. In any of its investment-decision applications, Real Option Theory reflects the reality that managers are not passive, but are able to actively adjust company operations as unforeseeable future conditions unfold.

Real Options Theory is not always as simple to use as computation-guided approaches, such as traditional NPV. It invites subjective judgments as to what could happen instead of focusing only on what is most likely to happen. Think, for example, of putting only enough gasoline in an automobile to safely make a scheduled trip of 100 miles. A traditional NPV approach buys the minimum amount of gasoline because less gasoline reduces investment cost without jeopardizing the scheduled trip. Conversely, Real Options Theory leads management to consider the value of putting an extra amount of gasoline in the automobile—based on the probability that an unanticipated but potentially profitable side trip should be taken during the originally scheduled 100-mile trip. In other words, investing for just the scheduled 100-mile trip does not allow the flexibility to seize an attractive—but unexpected—opportunity. The value of this flexibility involves managerial judgments. The same holds true in evaluating a threat, such as getting a flat tire—would you make this trip without a spare tire? A strictly profit-maximizing approach may seek to reduce costs by recommending against purchasing a spare tire. What is the value of having a spare tire? This is the kind of judgment decision overlooked by traditional NPV calculations. A company might invest in a power plant that can switch between natural gas and wood fiber in generating electricity so that future power needs can be satisfied by

whichever method is cheaper. The initial cost of this switching flexibility might be high and so traditional capital budgeting calculations might favor low cost, less flexible alternatives. But, if the other side of low-cost is an inability to cope with volatile fuel prices, then traditional methods give the wrong answer.

Real Option Theory is a better tool, one that values flexibility, and its proper application will serve managers who desire to make their organizations more resilient to economic stress.Real Option Theory, as understood by Brealey, Myers, and Allen, suggests that both the size of individual investments and whether or not these investments can be altered over time matter in terms of market value. Why? Because investments that are scalable permit decision makers to follow initial successes with follow-on investments and to cut losses in the event of failure. This scalability, in and of itself, creates value that cannot be seen with traditional capital budgeting methods. Trigeorgis recognizes that decision makers using traditional capital budgeting tools are not valuing their own ability to take an active role in managing economic resources into the future.

Investments that are reversible also create value. The flexibility of a firm is directly related to the degree that its investments are reversible. In any event, as a company takes steps to increase its resilience, it should expect to be able to afford more inflexibility in some of its investments. Strategic resilience comes at a cost, and managers may quickly find that its development places constraints on profits. Much like with other core competencies or "competitive advantages" of a company, resilience requires an investment to develop and maintain. Core competencies lead to a company's success in its markets, and benchmarking against the competencies of competitors may mandate larger investments just to

remain competitive. Even when financial analyses indicate that investments into certain core competencies are not fiscally prudent, managers may choose to make these investments because of strategic goals, such as staying at the forefront of some relevant technology.

Every company needs to ask itself what level of financial resources should be held in reserve? Different levels will be appropriate for different companies, and resilience may affect profits in different ways. The costs of developing resilience may reduce profits; however, resilience contributes to continued company survival. Choosing a specific level of a company's strategic resilience requires periodic judgments that balance its value against its costs. Such judgments are further complicated by situations where resilience may actually increase profits by allowing a company to seize unexpected opportunities.

When performing financial analyses, managers need to consider how all of the company's competencies can assist in their efforts. For example, a company may have a "captive buyer" for whom the company is the only possible source for its vital inputs. This kind of company could potentially pass cost increases along to its customers, thereby using its "marketing competency" to maintain financial resilience.

Alternatively, for a company that cannot pass its cost increases along to customers, hedging may be desirable. Hedging may reduce the future profits of a company, but it can allow this company to offer stable prices to customers at a profit for the long-term. Some companies have customers that expect stable prices, while others have customers that accept price fluctuations. For example, a coffee shop may hedge its purchases of coffee because its patrons expect to pay customary prices for standard sized cups. Conversely, a gasoline station operator might not hedge gasoline purchases because customers are used to paying fluctuating gasoline prices. The key is to leverage your strengths against economic uncertainty. Each company will need to assess its core competencies and strategize as to how they can be best utilized in developing the ultimate core competency of resilience. As a company selects investments, decisions regarding financing needs and capital structure can affect company resilience, and therefore require strategic consideration. For example, resilience will decrease as financial leverage increases, because large debts impose cash-flow burdens that reduce flexibility. This is

especially troublesome for small businesses because of their tendency to rely on debt financing.

There are other aspects of capital structuring that are often considered, but managers of firms large and small should always remember that companies can increase their resilience by reinvesting profits back into the firm. Such equity can be used to grow the firm or to pay back borrowed money. Internal financing of growth avoids the possibility of immense debt burdens arising when a new "star" product's sales grow rapidly. Large debts can develop because a company must usually pay for its production and distribution costs before the product can be purchased by customers. Customers may make matters worse if they further delay payment for their credit purchases. Rather than acquire a huge debt burden for financing a high-potential product's growth, a small company may make a strategic decision to sell the star product to a larger company that can more safely handle the financing.

As a company implements strategic plans, financial managers should be alert for opportunities to use flexibility in the necessary operational activities. This is yet another tool to improve or preserve profits throughout the business cycle. Brealey, Myers, and Allen note that within the context of volatile product markets, the ability of a firm to alter the nature and quantity of inputs and outputs in response to changing prices creates shareholder value. And this flexibility works to create value to the degree that prices are volatile—the greater the volatility in prices for inputs and/or outputs, the more valuable flexible production methods become. This flexibility can serve to offset some of the harm done when sales volumes are reduced. C.K. Prahalad has studied companies in India that are able to deal with highly volatile business conditions by using "strategic clarity and consistency" to guide "agility and resilience in operations." He identifies companies that are able to succeed at 30 percent to 40 percent capacity utilization, noting that agility in changing operational activities is vital to resilience.

Any organization that possesses a core competency can succeed during times of economic prosperity. Only those that are resilient can survive economic change. Flexible organizations are able to adjust to economic fluctuations while keeping these core competencies intact. This flexibility must extend to the company's capital investment policy. Managers who employ Real Option Theory can evaluate

capital investment opportunities in terms of their flexibility, favoring capital commitments that do not put the future of the organization in jeopardy. This approach, followed by the aforementioned steps, will help optimize a company's resilience through its financial decision-making processes. Traditional capital budgeting methods will not help managers to do this work.

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