

## Firm Financial Policy

AlexandruNEGREA<sup>1</sup>, Alexandra IONESCU<sup>2</sup>,  
<sup>1,2</sup>"Ovidius" University of Constanța  
ngraalexandru@yahoo.com, al3xandra\_ionescu@yahoo.com

**Abstract:** *Financial policy outlines the main directions of action of the financial activity. In determining financial policy, managers must take into consideration interests of all stakeholders, given the political, social, financial and monetary context of the firm, but also the technical and technological one. In addition, the educational, environmental and scientific context must be considered when establishing the financial policy, as it also influences the latter. Therefore, within financial policy, managers must identify and adopt those financial decisions that can positively influence the future development of the firm. Present studies intended as a tool for those interested in the future of the firm, e.g. employers, employees, banks, insurance companies, service providers, etc. It details directions of actions used by managers within financial policy in order to increase firm profits.*

**Keywords:** financial decisions, efficiency indicators, financial performance, profit function.

**JEL Classification:**G30.

### 1. Introduction

Economic growth can be achieved mainly through the organization of firms on efficiency criteria, taking into account all factors that may affect financial results. Determining the financial policy of the company is the primary purpose of financial activity. The starting point in achieving this goal is to clearly define the economic, political, social, financial and monetary context of the firm, the present and forthcoming one. Moreover, the technical and technological context, the educational, environmental and scientific one play an important role. These facts directly influence training, rehabilitation, development and operation of companies.

Free movement of capital, labor and goods produced significant changes in emerging economies. Market economy, based mainly on competition and prioritization based on supply and demand implies a continuing to increase the competitiveness of their products. The financial manager must investigate, identify and apply those financial decisions that lead to reduction of unit costs so that products become competitive.

### 2. Financial policy

Financial policy reflects the interests of the managers. Still, these interests must be correlated to all parties involved: owners, employees, state, economic and capital market, banks, etc. Financial decisions, but also financial substantiation of key economic decisions that affect production processes must be taken within this restrictive area.

The manager of a company can use financial policy instruments to boost economic and financial results of the firm.

Firm financial policy is achieved by accomplishing motivational and financial management functions. Along with running the financial allocation process, managers

must ensure the increase of firm's economic and financial results. They need to allocate funds so as to ensure the future development of the company together with payment of the financial and economic obligations to shareholders, partners, employees, state, banks, insurance companies, etc.

Consequently, the following motivational functions will be achieved:

- 1) Restore potential firm performance;
- 2) Solve conflicts and satisfy the interests of all participants within economic processes;
- 3) Ensure participatory leadership.

Choosing the right financial policy depends on the manager's ability to interpret the actual situation of the company and to forecast future situations, but also on his capacity to attract employees and employers in a participatory leadership. This form of leadership is able to lead to improvements in business performance, resolve conflicts inside and outside the firm and meet major interests.

Within the production process, proper value allocation has great influence on future financial and economic performance of the company. Therefore, the financial manager is obliged to act in accordance with the requirements of financial distribution, with all elements within firm structure, with firm interests and business development, and especially with efficiency indicators.

Financial utility of the efficiency indicators is to substantiate intervention for correcting the production processes, meaning transformation - conservation of the economic potential within products, within normal efficiency expected by market and owners.

Directions of action are aimed at restricting immediate payments for services and improve the transformation - conservation indicator, but also at correlating production decisions to projected or maximum production capacity.

If information meets this requirement, the financial department adopt and implements financial - monetary decisions related to production.

### 3. Financial - monetary decisions related to production

To favorably influence the economic efficiency (particularly by increasing profits), managers need to undertake several actions with technical, economic, social, etc. impact, by considering suggestions of the financial department. Their actions may have the effect of accelerating financial results, acting as a true leverage in increasing the profits.

In economic practice, several actions are known as having a leverage effect:

- 1) Increase of production;
- 2) Increase of fixed assets endowment (increasing technicality);
- 3) Reduction of total costs (fixed and variable).

**1) The increase of production (Q)** acts as a linear and accelerated growth factor of profit (through its influence on the level of fixed costs per unit of product). To represent the accelerating factor of the profit function, we start from the following function:

$$Pr = f \{ Q [ P - ( CV + CF/Q) ] \}$$

where:

Pr = total profit;

Q = projected quantity to be produced;

P = projected price per unit;

CV = total variable costs of the firm;

CF = total fixed costs of the firm.

If large parentheses in the above relation represents profit per unit (denoted by  $p$ ), then the factor that accelerates profit function is determined by deriving this function:

$$Pr' = [(Q + h)p - Qp] / h = hp/h = p$$

where:

$Pr'$  = first derivative of profit function,  $Pr = f(Qp)$ ;

$h$  = increase of production from a given quantity  $Q$ ;

$p$  = profit per unit.

Previous relation shows that the profit acceleration factor is profit per unit, determined by the increase in the amount of products produced.

For example, we will discuss the following assumption:

A firm produces 100000 units of product A, it predicts to sell these products by Lei 2 ( $P$ ) per unit, with a variable product cost Lei 1.2 (CVM) and Lei 40000 total fixed costs (CF). Researching the market, the company believes it can increase production from 100000 units to 120000 units ( $Q + h$ ).

Possible profit resulting from production of 100000 units ( $Q$ ) is:

$$Pr_0 = 100000 [2 - (1.2 + 40000/100000)] = 100\ 000 [2 - 1.6] = \text{Lei } 40000.$$

Projected profit resulting from the increase of production to 120000 units is:

$$Pr_n = 120000 [2 - (1.2 + 40.000/120000)] = 120000 [2 - 1.53] = \text{Lei } 56400.$$

Of this amount, the increase is Lei **16400** and is due to:

- The increase of production - 20000 units  $\times$  0.40 profit / unit = Lei **8000**;
- The reduction of fixed costs per unit 120000 units  $\times$  (0.4 - 0.33) = Lei **8400**.

**2) The increase of fixed assets endowment.** Additional endowment with high-tech assets determines economic effects with both direct and indirect consequences on firm financial results. Thus, by equipping firm with fixed assets, fixed costs will increase (depreciation) and, logically, variable costs (employees' wages) will be reduced due to job cuts, mainly as a result of introducing more efficient fixed assets.

Referring to the previous example, the growth coefficient (leverage) considers an increase in fixed costs (CF) from Lei 40000 thousand to Lei 50000 thousand and a reduction in variable costs per unit from Lei 1.2 to Lei 1.1.

We consequently have the following relation:

$$CI = Q (P - CVM) / [Q (P - CVM) - CF]$$

Leverage coefficient (CI) due to additional fixed asset endowment changes from the current (initial) one:

$$CI_0 = 100\ 000 (2 - 1,2) / [100\ 000 (2 - 1,2) - 40\ 000] = 2,00.$$

to the possible one:

$$CI_n = 100\ 000 (2 - 1,1) / [100\ 000 (2 - 1,1) - 50\ 000] = 2,25.$$

where:

$CI_0$  = the initial leverage coefficient;

$CI_n$  = the possible leverage coefficient;

CVM = average variable costs.

**3) Reduction of total costs.** Direct measures to reduce costs, both fixed and variable, have the most important effects on accelerating the profit function, therefore leverage is obvious.

Using the above relation, we can determine the change in the profit function due to the reduction of the average variable cost to Lei 1.0 and that of the fixed cost to Lei 35000 lei. Consequently, we have the following result:

$$Pr_m = 100000 [2 - (1.0 + 35000/100000)] = \text{Lei } 65.000$$

The increase from the initial situation ( $Pr_0 = \text{Lei } 40.000$ ) is that of Lei **25.000**.

where:

$Pr_m$  = total possible profit.

Presented directions of action produce immediate effects and are most used by firm financial managers. In the contemporary economy, any conservative, static attitude of the firms' management can result in loss of markets, reduced income, decreasing profits and, ultimately, bankruptcy of a firm.

#### 4. Projection of the financial dimension of the firm

As a link within financial system, firms have many dimensions, namely:

1. *Techno-economic dimension*. This dimension presents the firm as a resultant of the technical and economical progress, nationally achieved or imported. Financial projection should take into account this first dimension of the firm, as it influences consumption within the production process, but also the quality and extent.

2. *Managerial dimension*. Through this dimension, firms assimilate the progress of macro and micro-economic methods of management at any given time and adapts to the changes in the structure and forms of ownership. Financial activity, itself a managerial activity, needs to support the improvement of regulation and control processes within enterprise financing. It also has to contribute to the strengthening of the relations between the different types of property that emerge in economic units.

3. *The social dimension*. This dimension refers to the fact that the firm is increasingly under the influence of social forces, both internal and external. No financial decision will be adopted without cooperation with external institutions (either in the sense of providing funds or in the sense of applying for funds), inclusive lying privately owned companies.

4. *Environmental dimension*. This dimension appears as a natural one due to the fact that environment provides favorable conditions for businesses to evolve, it bears the negative effects of business processes and it claims funds for protection and rehabilitation.

5. *The financial dimension*. From a financial point of view, firms seek to come under the qualitative and quantitative restrictions of national and international credit, financial and capital markets.

*Financial projection seeks to define financial dimension of the firm as accurate as possible and to adapt it to the changes of the external financial market, by taking into account all other firm dimensions.*

After correlating all firm dimensions with its external environment, financial projection shall evaluate:

- firm consumption in the immediate or short term perspective;
- firm future production;
- firm's financial contact with the external environment on the short, medium and long term;
- firm liquidation in case of failure.

#### References

- Bistriceanu, G., Adochiței, M., Negrea, E., (2001), *Finanțele agenților economici*, Editura Economică, București.
- Bran, P., (2003), *Finanțele întreprinderii*, Editura Economică, București.
- Hoanță, N., (1996), *Finanțele firmei*, Editura Continent, Sibiu.
- Văcărel, I., (1996), *Politici economice și financiare de ieri și de azi*, Editura Economică.