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INTERACTIONS BETWEEN BUSINESS AND FINANCIAL STRATEGIES IN SERBIAN COMPANIES

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ABSTRACT: *We surveyed financial and general managers of 58 companies in Serbia in order to examine their views on the interactions between business and financial strategies. Although the theoretical views are well known and clear, in practice, when there is limited availability of funding sources, a meaningful combination of business and financial risk can be very difficult.*

We found moderate interactions between business and financial strategies. Managers of companies in Serbia are very aware of the fact that the high volatility of operating profit suggests that they should limit borrowing. However, ordinary practical problems in day-to-day operations, such as long periods of collection of accounts receivable, force the companies to take additional debt. There are significant differences between the views of managers of large companies

and managers of small businesses on how business strategy dictates financial strategy. However, firm size is not relevant to the current level of debt, although earlier decisions on business strategy in terms of diversification and internationalization are relevant to the level of leverage. Somewhat surprisingly, the current level of debt does not affect the intended financial strategy in the sense of the managers' preferences to take additional debt to finance possible diversification and internationalization or other high-risk financially demanding business strategies. As the pecking order theory advocates, managers have a strong tendency towards internal financing.

KEY WORDS: *business strategy, financial strategy, diversification, internationalization, capital structure*

JEL CLASSIFICATION: M10, G32

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1. INTRODUCTION

Managing the value of companies involves making operating, investment, and financial decisions. These decisions directly affect the individual drivers of value included in the “shareholder value network” (Rappaport, 1986, 1998).

Many operating and investment decisions should be made in accordance with the intended business strategy, and financial decisions should be made in accordance with the intended financial strategy. The adoption of each of these strategies is not an isolated process: due to the enhancing effect of combining business and financial risk the interaction of business and financial strategies should be clear. Companies with higher inherent business risk should be more careful in their use of debt. On the other hand, the current level of debt should probably affect the intended business strategy.

In practice, besides the beliefs and preferences of managers, which of course depend on their education, numerous other factors can also affect manager’s decisions. Some of these factors define companies’ business profiles and are also likely to shape managers’ preferences. It is expected that managers of large and small companies will have different attitudes as well as managers of companies in different industries. Furthermore, the company’s current financial profile should also be important - managers in companies that are already highly leveraged should have a lower preference for additional debt. However, in emerging markets the range of available funding sources is much smaller than that presented in standard corporate finance textbooks, which are mainly based on the practice of huge U.S. corporations. Therefore, the realized strategy may vary significantly from that intended.

Companies from different industries and of different sizes vary according to the financial and business strategies that have been implemented and are planned. As a company grows it usually enters into new areas of business and growth opportunities are sought through internationalization. However, this does not happen in the same way in all industries. Each industry has different characteristics: different technologies, processes, assets, and cost structures, different business models, competitive structures, degrees of consolidation, stages of development, etc. Specifics occur depending on whether the market is developed or emerging.

The focus of this paper is the investigation of the interaction of the business and financial strategies of Serbian companies. The paper aims to fill the lack of

research on the relationship between the two strategies in companies in Serbia and to compare the results of our study with similar studies conducted in other countries. We will first present the conceptual connection and theoretical foundation of this relationship, then we will present the research methodology, and finally we will discuss the findings.

2. THEORETICAL BACKGROUND AND LITERATURE REVIEW

Business strategy is the guiding principle behind the realization of a unique position in a chosen market segment (Djuričin, et al., 2014, p.84). Strategy is formulated on three levels: the corporate level, the level of business units, and the level of business functions. At the corporate level (general or corporate strategy) it determines the growth of the company; whether to embark on intensive growth, diversification, stabilization, or retrenchment. Grant (1998, pp.315-316) points out that general strategy addresses product scope, geographical scope, and vertical scope.

Product scope is determined by the level of specialization and diversification. Diversification is the direction of the company's growth, which in the context of the Ansoff matrix, i.e., the product-market matrix (Ansoff, 1957), implies that a company seeks sources of growth in new products and new markets. It can be related or unrelated: related diversification is aimed at operational synergy, and unrelated diversification is aimed at financial synergy. Although diversification means entering unknown, new business areas, it is often considered that this strategy leads to external flexibility: a company's operating profit no longer depend on a single business, and thus diversification leads to reduction of risk.

All diversified companies are not at the same level of diversification. The level of diversification is described by the Specialization Ratio (Rumelt, 1974), the ratio of the firm's annual revenue from its largest business to its total revenue. Companies with $SR \geq 0.95$ are undiversified, which means that almost all the revenue is coming from one business. Moderately diversified firms are firms with $0.95 > SR \leq 0.7$, and highly diversified firms are firms with $SR < 0.7$ (usually conglomerates or companies with a minimum degree of connectivity).

Geographic scope refers to the geographic spread of a company's business operations, whether local, national, or international. When a business is internationalized it expands its market beyond the national economy through

greater geographic coverage. This is more common for large companies than for small and medium companies.

Another element of the general strategy is vertical scope and coverage of the value chain. If a company has more generic value-chain activities on a business level it is about vertical integration. If a company transfers certain activities to its partners for execution it is about outsourcing.

Business strategy often involves making decisions in order to increase the sale of existing and new products, which is a form of market expansion. It can be an aggressive marketing strategy that is implemented with the aim of increasing market share (suppressing competitors) or penetrating new market segments. This strategy is also characterized by strong brand promotion.

Financial strategy focuses on determining the target capital structure and aims to minimize the weighted average cost of capital (WACC) and maximize company value. Capital structure is and has been the subject of numerous empirical studies and several theories. According to the trade-off theory (Kraus and Litzenberger, 1973) managers balance the tax benefits of debt against the costs of financial distress trying to reach optimal capital structure. Companies with higher bankruptcy costs tend to reduce these costs by reducing the debt. In addition, the capital structure is directly influenced by considerations of agency costs (Jensen and Meckling, 1976). There are two kinds of agency costs - agency costs of equity and debt. Agency costs of equity include the principal's monitoring expenditures, the agent's bonding expenditures, and residual losses. Agency costs of debt include, beside the monitoring and bonding expenditures (by both the lenders and the manager) and residual losses (the opportunity costs induced by impact of debts on the investment decisions), bankruptcy and reorganization costs.

Capital structure decisions depend on other factors. One of them is information asymmetry, which in the context of financial decision-making means that a company does not disclose the actual quality of its cash flows (Hol and Wijst, 2008). Flannery (1986) points out that firms with lower information asymmetry (for example, public utilities) often opt for financing by long-term debt. Conversely, companies with a higher level of information asymmetry (financial institutions) tend to be increasingly financed from short-term debt. According to the pecking order theory (Myers and Majluf, 1984) managers will prefer first, internal financing; second, debt; and lastly issuing equity. Antoniou et al. (2008) point out that leverage is positively influenced by asset tangibility and firm size.

Also, inadequate profitability leads to the growth of debt when the activity level is maintained (Djurićin and Vuksanović, 2013, p. 298).

Although the widely accepted view is that financial strategy is passive in relation to business strategy and its instrument, as was pointed out by Donaldson (1994), we cannot overlook the fact that financial conditions, i.e., capital structure, determine the intended business strategy.

Perhaps the experience of post-leveraged buyout (LBO) companies represents the extreme and most convincing example of how financial strategy affects business strategy. High level of debt can have a disciplining effect on managers of companies with positive free cash flow (FCF) for two reasons: the risk of reinvesting the funds in projects with negative net present value (NPV) is reduced and managers' motivation is increased. While the first is self-explanatory, the managers will be motivated to perform better and to apply disciplined business and investment strategies to ensure debt repayment primarily because otherwise their jobs might be in jeopardy. The management team seeks to increase and stabilize operating results through cost cutting and changing marketing strategy. Other measures that are usually implemented are fundamental changes in: the managers' compensation scheme, business processes, inventory control, product quality, product mix and sales services, downsizing, relationships with suppliers and customers, etc. The common goal of all the above-mentioned activities is increasing the company's generated FCF in order to ensure proper servicing of high debt.

A detailed overview of the literature shows several characteristics that shape interactions between business and financial strategies, of which the most important are size, industry, diversification, and internationalization.

Size. Because of the size of their assets and the wide range of assets that can be used as collateral, large companies are more likely to rely on debt. It is widely believed that larger firms are less risky than smaller firms, especially in terms of default risk (Fama and French, 1992). One of the reasons that larger firms are less risky is that, if the returns of individual corporate assets are not perfectly correlated, larger firms will have a smaller variance of earnings before interest and taxes (EBIT) than small companies. Frank and Goyal (2009) conducted extensive research into public companies in the United States in 1950-2003 and showed that larger companies (measured by book assets) tend to have high leverage. Graham (2000) found that large, profitable, liquid firms use debt sparingly.

Industry. Each industry is characterized by its business risk profile. Many factors determine an industry's business profile: the stability of demand (cyclical and seasonal components), labour and capital intensity, the share of labour costs in total costs, investment in R&D, the degree of competition in the industry, instruments competing for the favour of consumers, environmental risks, dependence on climate, etc. In this regard, it is expected that companies with similar business profiles will have a similar debt ratio. Some additional reasons are: similar assets structure, similar technology, liquidity requirements, method of obtaining loans, mortgage assets, and the level of profitability and growth.

Bradley et al. (1984) conclude that industry strongly influences firms' leverage ratio, where the influence originates from earnings volatility. Earnings volatility is inversely related to the debt ratio, as well as the intensity of investment in R&D and marketing. MacKey and Phillips (2002) point out that the optimal capital structure for some industries cannot be identified, and technology and risk significantly affect changes in capital structure. Remmers et al. (1974) conducted a comprehensive study on the impact of industry and size of company on the financial structure of five countries, using statistical analysis to prove that industries are not the determinants of capital structure in the Netherlands, Norway, and the United States, and are the determinants in France and Japan. Nor does the size of the company appear to be a key determinant of the debt ratio. Moreover, small businesses have a higher debt ratio than large companies in all of the above listed countries except the United States.

Diversification. Except in the case of perfect correlation of net cash flows produced by business units (correlation coefficient of +1), operating in more industries (i.e., diversification) always reduces instability in free cash flows. In this sense, company diversification reduces business risk, which means that these companies can be exposed to greater financial risk. On the one hand, the existence of internal capital markets in diversified companies enables capital allocation into the businesses with the best opportunities, while substitution of external capital markets can be interpreted as a disadvantage, since by definition this internal capital market is less efficient than the external market. Other disadvantages include the inability to ensure competent management in various businesses, waste of resources, and a lack of strategic fit that could be turned into a competitive advantage.

La Rocca et al. (2009) confirm that diversification affects decisions on capital structure: diversified firms have a higher debt ratio relative to undiversified firms, and related diversified firms have a lower ratio of debt relative to specialized firms, while unrelated diversified firms have higher level of debt ratio. On the

other hand, Chkir and Cosset (2001) find that multinational corporations with higher levels of international and product diversification have lower default risk and that companies with low levels of diversification have lower leverage.

Internationalization. Internationalization leads to higher business risk because new markets have certain specifics and uncertainties compared to domestic market. Uncertainties related to the general environment require a higher discount rate during international project evaluation (Reeb et al., 1998). However, geographic diversification disperses commercial risk in the sense that the overall result is not dependent solely on the domestic market. For this reason it is useful to examine whether companies that have internationalized their operations reduce the level of financial risk. On the other hand, debts in currencies other than the reporting currency can be seen as a natural hedging of currency risks arising from sales in another currency. Yee and Cheah (2006) argue that financial leverage is negatively correlated with the level of internationalization. According to them, since internationalization generally leads to higher level of business risk, financial leverage should be lower.

3. OVERVIEW OF RESEARCH METHODOLOGY

The research was conducted through a survey of CFOs (or CEOs) of 58 companies for the period 31/03/2014 to 16/04/2014.

Managers had to provide answers to all questions, because it was technically impossible to return an incomplete questionnaire. The questionnaire contained questions about the name and ID number of the company, but it was made clear to the managers that these data would not be publicized. The questionnaire contained two parts, the first with questions related to the basic characteristics of the company and the second containing questions about managers' attitudes to the interaction of business and financial strategies. Attitudes were examined using a five-point Likert Scale, where we, in order to avoid central tendency bias, asked respondents to not follow the rule of giving neutral ('middle option'), socially desirable answers, as they do not exist and there is no right or wrong answer.

As a proxy for *the size of the company* we used data on Total Assets obtained from the Serbian Business Registers Agency website. Managers selected *industry classification* from the following list: food processing (and beverage) industry, other processing industries, retail, distribution, agriculture, and others. A

significant 46.55% of the firms in the sample belonged to the food processing industry. Previously implemented business strategies were represented by *level of internationalization*, measured by the percentage of sales generated in foreign markets; and *diversification*, measured by a) the number of industries in which the company operates, and b) the percentage of sales from the core business (industry). On average the companies operated in 1.79 different industries. Finally, *the current level of debt*, as a testimony of implemented financial strategies, was measured by the ratio of total debt (short-term plus long-term) to total assets. The average debt ratio of companies in the sample was 18.53%. Out of the total number of companies 20.69% were publicly quoted.

In order to determine more accurately how various firms’ characteristics affect leverage and managers’ attitudes, all companies in the sample were divided into five sets of two subsamples. The first was size: companies were divided into large (L), with total assets above 10 million euro, and small (S) with total assets of less than 10 million euro. Secondly, industries were classified into food processing companies (FP) and other industries (O). Then companies were divided into those with only domestic sales - non-internationalized (N-I), and companies that also generated revenue from sales abroad - internationalized (I). Companies were also classified into diversified (D), companies with a specialization ratio (SR) smaller than 0.95 and companies that operated in three or more industries, and undiversified (UnD) companies with SR>0.95. Finally, as in Graham and Harvey (2001), companies were classified as leveraged (L) when they had a debt ratio greater than 30%, and unleveraged (UnL).

A summary of the number of companies in each group (subsampling) is provided in Table 1.

Table 1. Sample characteristics

No of firms										
All	Size		Industry		Internationalization		Diversification		Debt	
	L	S	FP	O	N-I	I	UnD	D	UnL	L
58	21	37	27	31	17	41	42	16	36	22

Source: Authors’ calculations

We investigated managers’ attitudes towards the interaction of business and financial strategies by asking questions about: 1) the impact of business strategies on the intended financial strategy, and 2) the impact of the present financial profile

on the intended business strategy. As elements of the business strategy, which we will observe in the context of their impact on financial decision making and vice versa, for the purpose of our research we take the levels of internationalization and diversification, and we exclude the level of vertical integration.

In regard to the first, we asked managers what encourages and what limits the use of debt. Managers were asked to rate on a scale from 1 to 5 (1 meaning not important, 5 meaning very important) positions that reveal their attitude about how:

- High volatility of EBIT (high business risk) limits the use of debt (lower financial risk);
- Diversification (operations in more businesses) encourages the use of debt;
- Internationalization (sales in other countries) encourages the use of debt;
- Long periods of collection of accounts receivable force the use of debt.

Also, we asked managers to evaluate how they would finance the implementation of business strategies focused on significant market expansion which include an aggressive marketing approach, sales growth of existing products and introduction of new products, and strong product promotion, and require a bigger marketing budget. The modalities for responses were:

- Short-term debt;
- Long-term debt;
- External equity (by issuing new shares or equity provided by financial partner);
- Finding a strategic partner;
- Internal capital (internal financing),

where, in order to enable the selection of multiple sources of funding, for each modality a separate five-point Likert Scale (Never, Rarely, Sometimes, Most of the Time, Always) was given.

Since intended and implemented strategies are often different due to numerous internal and external, objective and subjective reasons, we wanted to examine the effect of implemented business strategies on the current financial situation (debt ratio). Therefore, we investigated how the implemented business strategies (size, diversification, internationalization) influenced financial strategy (debt ratio).

Regarding the influence of financial strategy on business strategy, we asked managers whether business strategy should be adjusted according to the present

financial standing of firm. We offered them a similar assertion with the same assessment scale:

- Level of debt affects decisions about extending the scope of business.

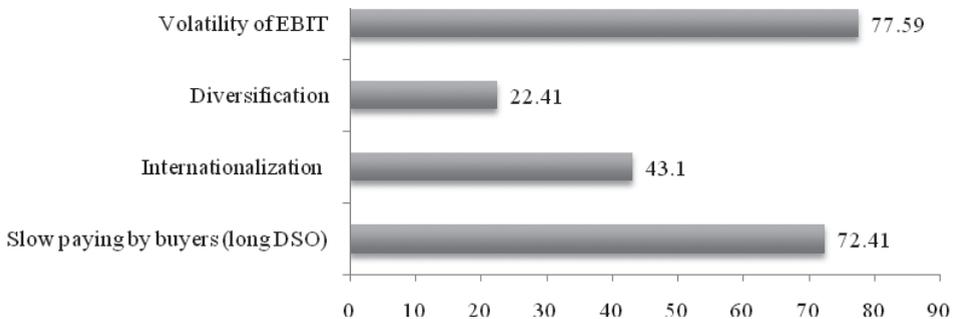
We ran t-tests to compare two sample means of groups of companies with different business profiles to determine if there is any significant difference between their managers' attitudes as well as between their levels of debt. When selecting a t-test for the analysis of the results obtained using a five-point Likert scale, we were guided by the conclusion of De Winter and Dodou (2010). They revealed, testing fourteen population distributions, that the t-test can be used instead of the Mann-Whitney-Wilcoxon test, as the two tests have equivalent power.

4. ANALYSIS AND RESULTS

4.1 The impact of business strategy on intended financial strategy

At first, we examined whether business strategy elements influence financial strategy and decisions on the use of debt. The survey responses are summarized in Figure 1 and Table 2.

Figure 1. The impact of business strategy elements on financial strategy



Source: Authors' calculations

Note: % of companies identifying factor as important or very important

Table 2. The impact of business strategy elements on financial strategy

	% of companies		Mean										
	Important or very important	Unimportant or of little importance	All	Size		Industry		Internationalization		Diversification		Debt	
				L	S	FP	O	N-I	I	UnD	D	UnL	L
Volatility of EBIT	77.59	4.26	4.103	4.048	4.135	4.148	4.065	4.059	4.122	4.095	4.125	4.056	4.182
Diversification	22.41	59.38	2.759	2.429	2.946*	2.667	2.839	2.882	2.707	2.690	2.938	2.667	2.909
Internationalization	43.10	39.02	3.103	2.667	3.351*	2.926	3.258	3.471	2.951*	2.952	3.500*	3.028	3.227
Slow paying by buyers (long DSO)	72.41	10.64	3.897	3.571	4.081*	3.778	4.000	4.059	3.829	3.833	4.063	3.833	4.000

* significant at the 0.05 level, ** significant at the 0.01 level.

Source: Authors' calculations

The greatest number of managers sees EBIT volatility as the most important factor of applied business strategy that influences decisions about borrowing: 77.59% believe it is an important or very important factor (mean 4.103). EBIT volatility can be viewed as a synthetic indicator of business risk in terms of implemented overall business strategy. This indicates that managers are well aware of the need to combine the effects of business and financial risks meaningfully. Less than 5% of surveyed managers, of companies of all different business profiles, thought that it is not important or of very little importance. However, managers do not believe that diversification and internationalization affect the level of debt. Diversification is not important or of very little importance for almost 60% of managers (with an average score of only 2.759). Internationalization has somewhat better results. These findings suggest that managers do not see either diversification or internationalization as an important tool for minimizing business risk.

In contrast to the views on diversification and internationalization, managers believe that a very practical problem is an important or very important factor of business strategy that determines the level of debt: delay of buyers in meeting their liabilities to the company. More than 72% of managers agreed with this assessment (a mean of nearly 3.9). Although companies can introduce measures such as stricter credit standards, shorter credit periods, and the intensification of measures in receivables collection policies, in the current business environment in Serbia most companies have limited ability to change credit management. The first reason is the chronic insolvency of a large number of companies. Meanwhile, solvent buyers are typically dominant buyers who have the bargaining power to

force long terms of payment and to impose their working capital management practices on the weaker supplier (Todorović, 2013). It is therefore not surprising that small firms are much more afraid of this problem than larger firms (4.081 versus 3.571). The difference was statistically significant.

We found additional statistically significant differences in attitude between managers of small and large companies in terms of how managers see impact of internationalization on level of debt (3.351 versus 2.667). Managers of small companies also believe more than managers of large companies that diversification encourages the use of debt (2.946 versus 2.429). Finally, not only managers of small companies but also managers of non-internationalized companies and diversified companies are more inclined to believe that internationalization encourages use of debt. In contrast to the previous results, interpretation of these findings is challenging. One possible explanation is that managers of small firms find that diversification requires a significant investment that cannot be provided through internal financing and it is necessary to arrange additional borrowing for this purpose. Similarly, managers of small companies and companies that do not generate revenues from foreign sales believe (or have a prejudice) that internationalization is big strategic change that inevitably causes increased debt. The view of internationalization that managers of diversified firms have may be influenced by their experience of additional borrowing to extend product scope (i.e., diversification), leading them to conclude that additional borrowing is also necessary when it comes to extending geographical scope. It is interesting that there was no difference of opinion between the managers of leveraged and unleveraged companies and between the managers of companies in different industries.

Regarding the second question about sources of financing for a strategy of market expansion, the majority of managers (72.41%) would always or most of the time chose internal capital as the preferred method. The managers were averse to any other source of funding. The least desirable method of financing was issuing shares or recapitalization by non-strategic partners: only 8.62% of managers would use this source of financing to expand markets (mean 2.431). The managers were also strongly averse to financing from short-term debt. The ranking list of funding sources by desirability is displayed in Figure 2 and a detailed summary of our results is given in Table 3.

Figure 2. Preferred sources of financing for a strategy of market expansion



Source: Authors' calculations

Note: % of companies who will always or most of the time use a given source of financing

Table 3. Sources of financing for a strategy of market expansion

Source	% of companies		Mean										
	Always or most of the time	Never or almost never	All	Size		Industry		Internationalization		Diversification		Debt	
				L	S	FP	O	N-I	I	UnD	D	UnL	L
Short term debt	10.34	82.86	2.483	2.286	2.595	2.444	2.516	2.471	2.488	2.429	2.625	2.556	2.364
Long term debt	20.69	68.42	2.552	2.381	2.649	2.667	2.452	2.235	2.683	2.476	2.750	2.444	2.727
Issuing stocks or finding a financial partner	8.62	84.85	2.431	2.143	2.568*	2.370	2.484	2.412	2.439	2.357	2.625	2.417	2.455
Finding strategic partner	20.69	67.57	2.621	2.429	2.730	2.630	2.613	2.412	2.707	2.571	2.750	2.583	2.682
Internal financing	72.41	14.29	3.724	3.905	3.622	4.037	3.452*	3.706	3.732	3.810	3.500	3.806	3.591

* significant at the 0.05 level, ** significant at the 0.01 level.

Source: Authors' calculations

The vast majority of managers (84.85%) told us that they would never or almost never issue shares or, in the case of privately owned firms, raise equity from partners who are non-strategic, i.e., financial. This and the strong preference for

internal financing comply with the view of the pecking order theory of capital structure. It is also obvious that in the absence of internal finance managers would miss the opportunity to improve their market position, because more than two-thirds of respondents would never or almost never raise the necessary funds through short-term (82.86%) or long-term debt (68.42%), or by trying to find a strategic partner to provide equity (67.57%).

Hoping that there might be a difference between managers of companies with different business profiles, we evaluated the results from the groups of companies. We discovered two significant differences: 1) managers of small companies are significantly less averse to the introduction of new investors in ownership, even financial investors (2.568 versus 2.143); 2) managers of food processing enterprises insist on internal financing significantly more than managers of other companies (4.037 versus 3.452). A possible explanation of the first finding is that small companies are faced with significantly smaller borrowing capacity, less available debt financing, and also smaller available internal capital than large companies, and so will accept this otherwise unpopular source of funding. Moreover, the explanation may be that the introduction of a financial partner in the ownership structure will provide fresh capital but will not lead to direct involvement in strategic decision-making, which would happen in the event of the introduction of a strategic partner. The second finding must be interpreted with care. One reason why companies in the food processing industry prefer internal equity might be that companies with strong brands have high profit margins and do not consider the use of external financing, and on the other hand, companies with low profit margins cannot cover high debt costs. Another reason is that in Serbia bank loans are usually tied to the euro, and in the case of a significant rise in the euro exchange rate the intense competition in this industry would prevent the additional costs being transferred to the buyers within a short period.

Interestingly, the current level of debt does not affect the preferred method of funding, even though it was expected that the managers of leveraged companies would be more averse to new borrowing or prefer the use of internal and external equity.

4.2 The impact of previously implemented business strategies on financial leverage

Although managers' attitudes and perceptions are certainly important in the design of financial strategies, on a practical level the realized strategy is influenced by other factors and may deviate from the intended financial strategy. Starting from the position of the pecking order theory, that the present capital structure is

nothing more than a reflection of past financial decisions, we wanted to examine whether these earlier financial decisions were shaped and tailored to business strategy decisions. If that were the case, companies' different business profiles would have to be accompanied by a different current capital structure. Our results suggest that level of diversification is significantly correlated with the level of debt. Leverage is also significantly correlated with the level of internationalization, but the relationship is weaker (see Table 4).

Table 4. Pearson correlation coefficients:
debt ratio and company characteristics

	Size	Internationalization	Diversification
Debt ratio	.150	.269*	.392**

* significant at the 0.05 level, ** significant at the 0.01 level.

Source: Authors' calculations

We tried to determine whether there are differences in the debt ratio between groups of companies with different business profiles. These results are presented in Table 5.

Table 5. Debt ratio

	Mean								
	All	Size		Industry		Internationalization		Diversification	
		L	S	FP	O	N-I	I	UnD	D
Debt ratio	18.53	20.67	17.32	21.63	15.84	10.65	21.80*	15.88	26.06*

* significant at the 0.05 level, ** significant at the 0.01 level.

Source: Authors' calculations

The results show that there are differences between different groups of companies in the debt ratio. Diversified companies have a much higher debt ratio than undiversified companies (26.06% vs. 15.88%) and the debt ratio of internationalized firms is more than twice the debt ratio of non-internationalized firms (21.80% vs. 10.65%). These findings fit the general theoretical view that financial risk has to be meaningfully combined with inherent business risk, as well as the results of previously conducted studies. They are consistent with La Rocca et al. (2009), who proved that diversified companies have a higher debt ratio, and partially consistent with the results obtained by Singh et al. (2003), according to which diversification alone leads to a higher debt ratio, internationalization alone leads to a lower debt ratio, and companies that follow a concurrent strategy of product and geographic diversification have a higher debt ratio.

We found no statistically significant difference in the level of debt ratio between the two industry subsamples sectors. Contrary to Frank and Goyal (2009) and Remmers et al. (1974), in our study we did not find a statistically significant difference between the debt ratio of small companies and the debt ratio of large companies.

We have to point out that these results do not agree with our previous findings that managers do not believe that decisions about diversification and internationalization significantly affect the level of debt. This probably reflects the fact that in practice, regardless of their attitudes, managers had to borrow funds to finance diversification and internationalization. That was probably forced by low profitability and consequently low internally generated capital, and limited available external equity.

4.3 The impact of financial leverage on intended business strategy

A company’s financial condition can influence the intended business strategy. Since we have looked at business strategy primarily through diversification and internationalization, which represent ways of extending business scope, we wanted to examine the attitude of managers towards the effect leverage (level of debt) would have on that business decision. The results obtained are shown in Table 6.

Table 6. The impact of financial leverage on intended business strategy

	% of companies		Mean										
	Important or very important	Unimportant or of little importance	All	Size		Industry		Internationalization		Diversification		Debt	
				L	S	FP	O	N-I	I	UnD	D	UnL	L
Leverage affects decision about extending the scope of business	15.52	71.14	2.224	1.810	2.459*	2.074	2.355	2.529	2.098	2.143	2.438	2.333	2.045

* significant at the 0.05 level, ** significant at the 0.01 level.

Source: Authors’ calculations

The managers interviewed told us that level of debt is unimportant in defining business strategy. Only 15.52% of managers believe that a higher level of debt is an important or very important factor in making those business decisions (a mean of 2.224). This finding is consistent with our previous observations that there is no difference between the opinions of managers in leveraged and unleveraged companies. However, there is a statistically significant difference in the attitudes of small and large companies. Managers of small companies see high level of debt as a more significant factor in making decisions about extending business scope. Different views on this question can be interpreted as managers of small companies (which by their size have less business scope) seeing debt as a limiting factor in extending business scope. On the other hand, managers of large companies, which usually have significant internal capital (internal financing), do not see debt as a key source of funding.

5. CONCLUSION

Although the theoretical view of the relationship between business and financial risk, and hence the implicit connection between business and financial strategy, is well known and understood, empirical research on the interaction between these two central strategies is in fact a difficult task. Mutual pairing of these strategies is an especially difficult task for managers when the range of available sources of financing is relatively limited, as is certainly the case with companies in Serbia.

In this study we investigated the attitudes of managers of companies in Serbia, and based on their responses we have come to several important conclusions about the interaction of business and financial strategies. We found moderate interactions between those strategies; the influence of business strategy on financial strategy is moderate to relatively strong, but the influence of financial strategy on business strategy is relatively weak.

Although managers do not believe that diversification and internationalization, taken individually, significantly influence decisions about the level of debt that they will engage in, managers are aware of the fact that the volatility of EBIT, as a synthetic indicator of implemented business strategies, determines ability to borrow. Managers also believe that the level of debt is largely dictated by the regular settlement of obligations by their buyers, the choice of which represents an important aspect of applied business strategy. Firm size significantly affects the intended financial strategy. Managers of small companies are more

concerned that increasing days sales outstanding, entering new businesses, and/or internationalization may force their companies to increase debt.

Surprisingly, the current level of debt has no impact on managers' attitudes. This is true regarding both 1) the impact of business strategy on the propensity to borrow more, and 2) the choice of sources of funding to finance the implementation of a business strategy that requires a large amount of cash. By far the largest percentage of managers of companies of all characteristics would finance an aggressive business strategy exclusively or almost always with internal capital. Managers are averse to any other sources of funding: almost 85% of managers will never or almost never engage additional external equity either through the issue of new shares or, in the case of private companies, through the inclusion of a financial (non-strategic) investor in the ownership; and more than two-thirds of the managers would never or almost never take additional short- or long-term loans, or try to find a strategic equity investor for these purposes. These conclusions relate to managers' attitudes and intended financial strategies. However, an examination of realized financial strategies gives a different picture. Company size is not important, but the level of internationalization and the diversification of companies are. Internationalized and diversified companies have significantly higher levels of debt. This is probably largely because the diversification and internationalization per se caused the debt, not due to the belief that diversification and internationalization reduce business risk. This is also relatively strong evidence that managers' decisions may differ significantly from their attitudes, and implemented strategies may deviate from those intended.

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Received: September 02, 2014

Accepted: November 01, 2014