

Chapter 1: Introduction to Corporate Finance

Introduction:

An organisation needs finance for its various activities, operations and projects. It needs to ensure that there is enough finance at every stage of development i.e., right from incorporation to its maturity. In the incorporation stage, the organisation needs finance to develop its basic infrastructures, such as establishing plants and machinery. In the development stage, it requires finance to expand its business operations by entering into joint ventures and mergers and acquisitions and funding its working capital requirements.

Thereafter, in the maturity stage, the organisation needs finance to stay competitive in the business through effective advertisement and constant improvement in its products. The process of managing the funds of an organisation is called financial management.

Corporate finance plays a vital role in every business. Irrespective of the size or type of business operations, every company seeks to streamline its corporate financing arm for optimum wealth distribution and return generation. Corporate finance meaning thus extends to an array of financing and investment decisions that encompass four primary aspects, viz:

- Planning finances
- Raising funds
- Investing
- Monitoring

Corporate finance refers to activities and transactions related to raising capital for the creation, development and acquisition of a business. It is directly related to company decisions which have financial or monetary impacts. It can be considered as a liaison between the capital market and the organisation. The corporate finance definition also encompasses effective resource utilisation and expenditure minimisation. Factors that contribute to its decision include term requirements of the company, urgency, risk appetite, etc.

A business undertakes such decisions to achieve pre-set financial goals while ensuring maximisation of shareholder value.

Features of Corporate Finance

1. **Financial Activity** : Corporate finance is a financial activity. It includes planning, raising, investing and monitoring the finance of the company. In short, it includes all the financial aspects of the company. This work is done by the financial department headed by the finance manager.
2. **Raising the finance** : Corporate finance includes raising (collecting) finance for the company. Finance can be collected through shares, debentures, bank loans, etc. It is very difficult for new companies to collect finance because the investors do not have confidence in new companies. However, it is very easy for reputed companies to collect finance due to their well-established goodwill in the market.
3. **Investing the finance** : Corporate finance also includes investing (using) the finance. The finance is used to achieve the objectives of the company. It is used to purchase fixed assets. It is also used for running the company. The finance must be used profitably.
4. **Objective oriented** : Corporate finance is objective oriented. That is, it is used to achieve the objectives of the company. The main objectives are, viz., (i) To earn maximum profits, (ii) To give a proper dividend to the shareholders, and (iii) To create a proper reserve for future growth and expansion, etc.
5. **Types of finance** : There are two types of corporate Finance, viz., fixed capital and working capital. Fixed capital is also called long-term finance. It is used to meet the long-term needs of the company. It is used to purchase fixed assets. Working capital is also called short-term finance. It is used to meet the short-term needs of the company. It is used to pay the day-to-day expenses of the company. Medium term finance is also used to meet the medium term needs of the company.
6. **Relationship with other departments** : Corporate finance has a close relationship with all other departments in the company, i.e. Production Department, Marketing Department, etc. This is because all departments need finance continuously.
7. **Dynamic in nature** : Corporate finance is dynamic in nature. It goes on changing according to the changes in environment, circumstances, times, etc. So, the finance manager must use new and innovative ideas for collecting and investing money. He must use creativity while doing his job.
8. **Requires proper planning and control** : Corporate finance requires proper planning and control. Planning is required to collect finance from the investors. It is also required for investing the finance. Control is required to find out whether the finance is invested properly or not. If the finance is not invested properly, then corrective measures must be taken.
9. **Managing finance is an art and science** : Managing finance is an Art because it requires human skills and judgement. It is a Science because it follows a systematic approach.
10. **Legal requirements** : There are many legal requirements for corporate finance. The company has to take permission, from the Controller of Capital Issues, for collecting finance from the public. The company also has to follow all the rules of SEBI. A Sole Trader and Partnership Firm need not follow these rules.
11. **Important part of business management** : Corporate finance is an important part of business finance. "Finance is the life blood of business." Finance is required for all business activities. It is required for promoting business. It is required for

conducting the business smoothly. It is required for expansion, diversification, modernization, replacement of assets, etc. Finance is also required for paying taxes, dividend, interest and for meeting contingencies.

Need and importance of Corporate Finance

1. **Research and Development** : Corporate Finance is needed for Research and Development. Today, a company cannot survive without continuous research and development. The company has to go on making changes in its old products. It must also invent new products. If not, it will be get automatically thrown out of the market.
2. **Motivating Employees** : Manager and employees must be continuously motivated to improve their performance. They must be given financial incentives, such as bonus, higher salaries, etc. They must also be given non-financial incentives such as transport facilities, canteen facilities (eatery), etc. All this requires finance.
3. **Promoting a Company** : Finance is needed for promoting (starting) a company. It is needed for preparing Project Report, Memorandum of Association, Articles of Association, Prospectus, etc. It is needed for purchasing Land and Buildings, Plant and Machinery and other fixed assets. It is needed to purchase raw materials. It is also needed to pay wages, salaries and other expenses. In short, we cannot start a company without finance.
4. **Smooth Conduct of Business** : Finance is needed for conducting the business smoothly. It is needed as working capital. It is needed for paying day-to-day expenses. It is needed for advertising, sales promotion, distribution, etc. A company cannot run smoothly without finance.
5. **Expansion and Diversification** : Expansion means to increase the size of the company. Diversification means to produce and sell new products. Modern machines and modern techniques are needed for expansion and diversification. Finance is needed for purchasing modern machines and modern technology. So, finance becomes mandatory for expansion and diversification of a company.
6. **Meeting Contingencies** : The company has to meet many contingencies. For e.g. Sudden fall in sales, loss due to natural calamity, loss due to court case, loss due to strikes, etc. The company needs finance to meet these contingencies.
7. **Government Agencies** : There are many government agencies such as Income Tax authorities, Sales Tax authorities, Registrar of Companies, Excise authorities, etc. The company has to pay taxes and duties to these agencies. Finance is needed for paying these taxes and duties.
8. **Dividend and Interest** : The company has to pay dividends to the shareholders. It has to pay interest to the debenture holders, banks, etc. It also has to repay the loans. Finance is needed to pay dividends and interest.
9. **Replacement of Assets** : Plant and Machinery are the main assets of the company. They are used for producing goods and services. However, after some years, these assets become old and outdated. They have to be replaced by new assets. Finance is needed for replacement of old assets. That is, finance is needed to buy new assets.

Financial Management

Meaning

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

Scope/Elements

1. Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.
2. Financial decisions - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.
3. Dividend decision - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
 - a. Dividend for shareholders- Dividend and the rate of it has to be decided.
 - b. Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Objectives of Financial Management

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

In simple terms objective of Financial Management is to maximize the value of firm, however it is much more complex than that. The management of the firm involves many stakeholders, including owners, creditors, and various participants in the financial market.

Effective procurement and efficient use of finance lead to proper utilization of the finance by the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management

The objectives of financial management are given below:

1. Profit maximization

Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for the purpose of earning profit. Profit is the measuring techniques to understand the business efficiency of the concern.

The finance manager tries to earn maximum profits for the company in the short-term and the long-term. He cannot guarantee profits in the long term because of business uncertainties. However, a company can earn maximum profits even in the long-term, if:

- The Finance manager takes proper financial decisions
- He uses the finance of the company properly

The main aim of any form of business is to earn a profit. All the business entity operates to earn the maximum amount of return in terms of profits. Profit earning capacity is a measuring technique to evaluate the efficiency of the concerned business. **Profit Maximization** is the traditional and narrow approach that aims to maximize the profit for an organization.

Profit Maximization consists of the following features:

- Profit Maximization is also known as cash per share maximization. It helps in achieving the objects to maximize the business operation for profit maximization.
- The ultimate objective of any business is to earn a huge amount of return in terms of profit. Thus, this objective of financial management considers all the possible ways to increase the profitability of the business concern.
- Profit earning capacity is kind of a parameter for measuring the efficiency of a particular business. Thus, it shows the entire position of business along with the measures to improve and increase profitability.
- **Profit Maximization** is an objective that helps in reducing risk.

2. Wealth maximization

Wealth maximization (shareholders' value maximization) is also a main objective of financial management. Wealth maximization means to earn maximum wealth for the shareholders. So, the finance manager tries to give a maximum dividend to the shareholders. He also tries to increase the market value of the shares. The market value of the shares is directly related to the performance of the company. Better the performance, higher is the market value of shares and vice-versa. So, the finance manager must try to maximize shareholder's value

Wealth maximization is also called as value maximization or net present worth maximization. This objective of Financial Management is universally acceptable in all forms of business concern. It's one of the modern approaches that involve the latest innovations and improvement in the fields of business operations. The term wealth means shareholders' wealth or the wealth of the persons involved the business concern.

Wealth Maximization Objective is also known as "Value Maximization" or "Net Present Worth Maximization." This objective is considered appropriate for decision making. Wealth means wealth **of shareholders**. Wealth of shareholders is determined by **market value of shares**.

Wealth also signifies **Net Present Value(NPV)** which is the difference between present value of cash inflows and present value of cash outflows. In this way, wealth maximization objective considers time value of money and assign different values to cash inflows occurring at different point of time. So, according to wealth maximization objective, investments should be made in such a way that it maximizes Net Present Value.

Qualities of a Financial Manager

