CORPORATE FINANCE

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ABSTRACT

Corporate finance is the area of finance dealing with the sources of funding & the capital structure of corporations, the actions that managers take to increase the value of the firm to the shareholders, & the tools & analysis used to allocate financial resources. The primary goal of corporate finance is to maximize or increase shareholder value.Although it is in principle distinct from managerial finance which studies the financial management of all firms, rather than corporations alone, the main concepts in the study of corporate finance are applicable to the financial problems of all kinds of firms.

Every decision made in a business has financial implications, & any decision that involves the use of money is a corporate financial decision. Defined broadly, everything that a business does fits under the rubric of corporate finance. It is, in fact, unfortunate that we even call the subject corporate finance; because it suggests to many observers a focus on how large corporations make financial decisions & seem to exclude small & private businesses from its purview. A more appropriate title for this discipline would be Business Finance, because the basic principles remain the same, whether one looks at large, publicly traded firms or small, privately run businesses. All businesses have to invest their resources wisely, find the right kind & mix of financing to fund these investments, & return cash to the owners if there are not enough good investments.

Keywords: Corporate Finance, Investment, Dividend Principles, Fundamental Principles etc.

I. CORPORATE FINANCE

Corporate finance is the field of finance dealing with financial decisions that business enterprise make and the tools and analysis used to make these decisions. The primary goal of corporate finance is to maximize corporate value while managing the firm's financial risks. Although it is in principle different from managerial finance which studies the financial decisions of all firms, rather than corporations alone, the main concepts in the study of corporate finance are applicable to the financial problems of all kinds of firms. The discipline can be divided into long-term and short-term decisions and techniques. Capital investment decisions are long-term choices about which projects receive investment, whether to finance that investment with equity or debt, and when or whether to pay dividends to shareholders. On the other hand, short term decisions deal with the short-term balance of .current assets and current liabilities; the focus here is on managing cash, inventories, and short-term borrowing and lending.

Corporate finance covers every decision a firm makes that may affect its finances which can be grouped into five areas for the conceptual understanding.

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1. The first is the objective function, where we define what exactly the objective in decision making should be.
2. The second is the investment decision, where we look at how a business should allocate of resources across competing uses.
3. The third is the financing decision, where we examine the sources of financing and whether there is an optimal mix of financing.
4. The fourth is the dividend decision, which relates to how much a business should reinvest back into operations and how much should be returned to the owners.
5. Finally, there is valuation, where all of the decisions made by a firm are traced through to a final value

III. FUNCTIONS OF CORPORATE FINANCE

1. **Acquisition of Resources :** Acquisition of resource indicates fund generation at the lowest possible cost. Resource generation is possible through:

a. Equity : This includes proceeds received from retained earnings, stock selling, and investment returns.

b. Liability : This includes warranties of products, bank loans, and payable account.

2. **Allocation of Resources :** Allocation of resources is nothing but investment of funds for profit maximization1. Investment can be categorized into 2 groups:

a. Fixed Assets – Buildings, Land, Machinery etc.

b. Current Assets – cash, receivable accounts, inventory, etc. Broad Functions of Corporate Finance are :

(1) Raising of Capital or Financing

(2) Budgeting of Capital

(3) Corporate Governance

(4) Financial management

(5) Risk Management

IV. OBJECTIVE OF DECISION MAKING IN CORPORATE FINANCE

1. **Long term decisions :** This includes capital investment decisions like viability assessment of projects, financing it through equity and/or debt, pay dividend or reinvest the profit. Long term corporate finance decisions that are normally related to fixed assets and capital structure are known as Capital Investment Decisions. Senior management always targets to maximize the value of the firm by investing in projects having positive Net Present Value. If such opportunities are not arising then reinvestment of profits should be stalled and excess cash should be returned to shareholders in form of dividends. Thus, Capital Investment Decisions constitute 3 decisions :

(a) Decision on Investment

(b) Decision on Financing

(c) Decision on Dividend

2. Short term decisions :

These are also called working capital management decisions which try to strike a balance between current assets such as cash, inventories, etc and current liabilities i.e. a company's debts/obligations impending for less than a year.

V. PRINCIPLES OF CORPORATE FINANCE

The broad principles of corporate finance are:

1. Investment Decision
2. Financing Decision
3. Dividend Decision
4. Liquidity Decision

1. Investment Decision : The firm has limited resources that must be allocated among challenging uses. On the one hand the funds may be used to generate added capacity which in turn generates additional revenue and profits and on the other hand some investments results in lesser costs. In financial management the returns, from a proposed investment are compared to a minimum acceptable hurdle rate in order to accept or reject a project. The hurdle rate is the minimum rate of return below which no investment proposal would be accepted.

2. Financing Decision : Another important area where financial management plays an important role is in deciding when, where, from and how to acquire funds to meet the firm's investment needs. These aspects of financial management have acquired greater importance in recent times due to the multiple avenues from which funds can be raised. Some of the widely used instruments for raising finds are ADRs, GDRs, ECBs Equity Bonds and Debentures etc. The core issue in financing decision is to maintain the optimum capital structure of the firm that is in other words, to have a right mix of debt and equity in the firm's capital structure. In case of pure equity firm the shareholders returns should be equal to the firm's returns. The use of debt affects the risk and return of shareholders. In case, cost of debt is used the firm's rate of return the shareholder's return is going to increase and vice versa. The change in shareholders return caused by change in profit due to use of debt is called the financial deverage.

3. Dividend Decision : Dividend decisions is the third major financial decision The share price of a firm is a function of the cash flows associated with the share. The share price at a given point of time is the present value of future cash flows associated with the holding of share. These cash flows are dividends. The finance manager has to decide what proportion of profits has to be distributed to the shareholders. The proportion of profits distributed as dividends is called the dividend pay out ratio and the retained proportion of profits is known as retention ratio.

4. Liquidity Decision : A firm must be able to fulfill its financial commitments at all points of time. In order to ensure this the firm should maintain sufficient amount of liquid assets. Liquidity decisions are concerned with satisfying both long and short-term financial commitments. The finance manager should try to synchronise the cash inflows with cash outflows. An investment in current assets affect the firm's profitability and liquidity. A conflict exists between profitability and liquidity while managing current assets. In case, the firm has

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insufficient current assets it may default on its financial obligations. On the other hand excess funds result in foregoing of alternative investment opportunities.

Need of Corporate Finance

Finance is the life blood of business. It is required by all types of companies. It is required for starting a company. It is required for running a company. It is required for the survival, stability and growth of a company. It is required for expansion and diversification of a business. Finance is also required for closing down the company.

So, a company cannot survive without finance. It requires promotional finance to start the company. It requires long-term finance to purchase fixed assets. It requires development finance for growth, expansion and diversification of business.

VI. IMPORTANCE OF CORPORATE FINANCE

The following points bring out the 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 modem 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. **Divident 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.

VII. THE FIRM: STRUCTURAL SET-UP

In corporate finance, we will use **firm** generically to refer to any business, large or small, manufacturing or service, private or public. Thus, a corner grocery store and Microsoft are both firms. The firms investments are generically termed **assets**. Although assets are often categorized by accountants into fixed assets, which are long-lived, and current assets, which are short-term, we prefer a different categorization. The assets that the firm has already invested in are called **assets in place**, whereas those assets that the firm is expected to invest in the future are called **growth assets**. Though it may seem strange that a firm can get value from investments it has not made yet, high-growth firms get the bulk of their value from these yet-to-be-made investments. To finance these assets, the firm can raise money from two sources. It can raise funds from investors or financial

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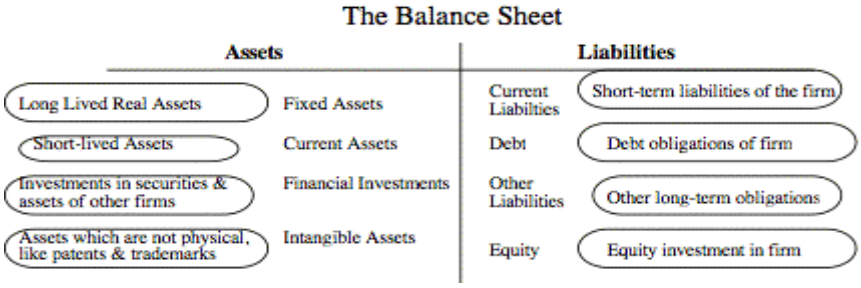
institutions by promising investors a fixed claim (interest payments) on the cash flows generated by the assets, with a limited or no role in the day-to-day running of the business. We categorize this type of financing to be **debt**. Alternatively, it can offer a residual claim on the cash flows (i.e., investors can get what is left over after the interest payments have been made) and a much greater role in the operation of the business. We call this **equity**. Note that these definitions are general enough to cover both private firms, where debt may take the form of bank loans and equity is the owners own money, as well as publicly traded companies, where the firm may issue bonds (to raise debt) and common stock (to raise equity).

Thus, at this stage, we can lay out the financial balance sheet of a firm as follows:

Note the contrast between this balance sheet and a conventional accounting balance sheet.



An accounting balance sheet is primarily a listing of assets in place, though there are some circumstances where growth assets may find their place in it; in an acquisition, what gets recorded as goodwill is a conglomeration of growth assets in the target firm, synergies and overpayment.

First Principles

Every discipline has first principles that govern and guide everything that gets done within it. All of corporate finance is built on three principles, which we will call, rather unimaginatively, the investment principle, the financing principle, and the dividend principle. The investment principle determines where businesses invest their resources, the financing principle governs the mix of funding used to fund these investments, and the dividend principle answers the question of how much earnings should be reinvested back into the business and how much returned to the owners of the business. These core corporate finance principles can be stated as follows:

1. **The Investment Principle**: Invest in assets and projects that yield a return greater than the minimum acceptable hurdle rate. The hurdle rate should be higher for riskier projects and should reflect the financing mix used—owners funds (equity) or borrowed money (debt). Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
2. **The Financing Principle**: Choose a financing mix (debt and equity) that maximizes the value of the investments made and match the financing to nature of the assets being financed.

3. **The Dividend Principle**: If there are not enough investments that earn the hurdle rate, return the cash to the owners of the business. In the case of a publicly traded firm, the form of the return—dividends or stock buybacks—will depend on what stockholders prefer.

When making investment, financing and dividend decisions, corporate finance is single-minded about the ultimate objective, which is assumed to be maximizing the value of the business. These first principles provide the basis from which we will extract the numerous models and theories that comprise modern corporate finance, but they are also commonsense principles. It is incredible conceit on our part to assume that until corporate finance was developed as a coherent discipline starting just a few decades ago, people who ran businesses made decisions randomly with no principles to govern their thinking. Good businesspeople through the ages have always recognized the importance of these first principles and adhered to them, albeit in intuitive ways. In fact, one of the ironies of recent times is that many managers at large and presumably sophisticated firms with access to the latest corporate finance technology have lost sight of these basic principles.

The Financing Principle

Every business, no matter how large and complex, is ultimately funded with a mix of borrowed money (debt) and owners funds (equity). With a publicly trade firm, debt may take the form of bonds and equity is usually common stock. In a private business, debt is more likely to be bank loans and an owners savings represent equity. Though we consider the existing mix of debt and equity and its implications for the minimum acceptable hurdle rate as part of the investment principle, we throw open the question of whether the existing mix is the right one in the financing principle section. There might be regulatory and other real-world constraints on the financing mix that a business can use, but there is ample room for flexibility within these constraints.

We begin the discussion of financing methods, by looking at the range of choices that exist for both private businesses and publicly traded firms between debt and equity. We then turn to the question of whether the existing mix of financing used by a business is optimal, given the objective function of maximizing firm value. Although the trade-off between the benefits and costs of borrowing are established in qualitative terms first, we also look at two quantitative approaches to arriving at the optimal mix. In the first approach, we examine the specific conditions under which the optimal financing mix is the one that minimizes the minimum acceptable hurdle rate. In the second approach, we look at the effects on firm value of changing the financing mix.

The Dividend Principle

Most businesses would undoubtedly like to have unlimited investment opportunities that yield returns exceeding their hurdle rates, but all businesses grow and mature. As a consequence, every business that thrives reaches a stage in its life when the cash flows generated by existing investments is greater than the funds needed to take on good investments. At that point, this business has to figure out ways to return the excess cash to owners. In private businesses, this may just involve the owner withdrawing a portion of his or her funds from the business. In a publicly traded corporation, this will involve either paying dividends or buying back stock. the discussion of dividend policy, we introduce the basic trade-off that determines whether cash should be left in a business or taken out of it. For stockholders in publicly traded firms, we note that this decision is fundamentally one of whether they trust the managers of the firms with their cash, and much of this trust is based on how well these managers have invested funds in the past. Finally, we consider the options available to a firm to return assets to its ownersdividends, stock buybacks and spin-offs—and investigate how to pick between these options.

Corporate Financial Decisions, Firm Value, and Equity Value

If the objective function in corporate finance is to maximize firm value, it follows that firm value must be linked to the three corporate finance decisions outlined investment, financing, and dividend decisions. The link between these decisions and firm value can be made by recognizing that the value of a firm is the present value of its expected cash flows, discounted back at a rate that reflects both the riskiness of the projects of the firm and the financing mix used to finance them. Investors form expectations about future cash flows based on observed current cash flows and expected future growth, which in turn depend on the quality of the firms projects (its investment decisions) and the amount reinvested back into the business (its dividend decisions). The financing decisions affect the value of a firm through both the discount rate and potentially through the expected cash flows.

This neat formulation of value is put to the test by the interactions among the investment, financing, and dividend decisions and the conflicts of interest that arise between stockholders and lenders to the firm, on one hand, and stockholders and managers, on the other. We introduce the basic models available to value a firm and its equity, and relate them back to management decisions on investment, financial, and dividend policy. In the process, we examine the determinants of value and how firms can increase their value.

SOME FUNDAMENTAL PROPOSITIONS ABOUT CORPORATE FINANCE

There are several fundamental arguments we will make repeatedly in this discussion:

1. **Corporate finance has an internal consistency** that flows from its choice of maximizing firm value as the only objective function and its dependence on a few bedrock principles: Risk has to be rewarded, cash flows matter more than accounting income, markets are not easily fooled, and every decision a firm makes has an effect on its value.

2. Corporate finance must be viewed as an integrated whole, rather than a collection of decisions. Investment decisions generally affect financing decisions and vice versa; financing decisions often influence dividend decisions and vice versa. Although there are circumstances under which these decisions may be independent of each other, this is seldom the case in practice. Accordingly, it is unlikely that firms that deal with their problems on a piecemeal basis will ever resolve these problems. For instance, a firm that takes poor investments may soon find itself with a dividend problem (with insufficient funds to pay dividends) and a financing problem (because the drop in earnings may make it difficult for them to meet interest expenses).

3. Corporate finance matters to everybody.

There is a corporate financial aspect to almost every decision made by a business; though not everyone will find a use for all the components of corporate finance, everyone will find a use for at least some part of it. Marketing managers, corporate strategists, human resource managers, and information technology managers all make corporate finance decisions every day and often don't realize it. An understanding of corporate finance will help them make better decisions.

4. **Corporate finance is fun**.

This may seem to be the tallest claim of all. After all, most people associate corporate finance with numbers, accounting statements, and hardheaded analyses. Although corporate finance is quantitative in its focus, there is a significant component of creative thinking involved in coming up with solutions to the financial problems

businesses do encounter. It is no coincidence that financial markets remain breeding grounds for innovation and change.

5. **The best way to learn corporate finance is by applying its models and theories to real-world problems.** Although the theory that has been developed over the past few decades is impressive, the ultimate test of any theory is application. As we will argue, much (if not all) of the theory can be applied to real companies and not just to abstract examples, though we have to compromise and make assumptions in the process.

VIII. CONCLUSION

Based on this paper the first principles that govern corporate finance. The investment principle specifies that businesses invest only in projects that yield a return that exceeds the hurdle rate. The financing principle suggests that the right financing mix for a firm is one that maximizes the value of the investments made. The dividend principle requires that cash generated in excess of good project needs be returned to the owners. These principles are the core for corporate finance.

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