

Chapter 3

Objectives, Functions and Importance of Corporate Finance

Scope of Corporate Finance

Corporate finance is the area of finance dealing with the sources of funding and the capital of corporations and the actions that managers take to increase the value of the firm to the shareholders, as well as the tools and analysis used to allocate financial resources. The primary goal of corporate finance is to maximize or increase shareholder.

1. Corporate finance broadly speaking business finance can be defined as the activity concerned with the raising and administering of funds used in business.

2. **Precedents.**—Corporate finance deals with precedents, practice and policies based on experience, accident or anticipation.

3. **Financial problem.**—Corporate finance deals with the financial problems of corporate. Also deal with distinction between capital and income.

4. **Capital required.**—It examines the extent form of capital required by corporate.

5. **Income.**—It scrutinizes the practice and policies of administering corporate income.

6. **Dividend.**—It looks into propriety of dividend, depreciation and reserve policies of the companies.

7. **Financial institution.**—It studies the importance of financial institutions insurance, stock exchanges, investment bankers, etc.

8. **Role of state.**—It examines the role of state in regulating and controlling the financial practices and policies of corporate.

9. **Divorce ownership and management.**—Management is provided with a number of opportunities to manipulate the financial statements. Corporate finance separate between ownership and management.

10. **Protector of shareholders.**—Corporate finance is likely to stand as a protector of shareholders.

A corporation is seen as a legal entity that has assets and liabilities as an individual and can be directly sued aside from its ownership. Corporate finance therefore deals with legal financial matter of these corporations in a general sense. However, it deal more specifically with financial investment and capital investment decisions, maximize shareholder value, and working capital

investment decisions. Many corporations therefore in corporate finance ensure maximization of profits.

Further it aims at discussing the management-shareholder problems often referred to in management as agent-principle conflict regarding wealth maximization/capital formation maximisation and profit maximisation/financial returns to investments.

Corporate finance is the study of capital, financial and investment decision making with the main aim of maximising capital market shares value and returns for shareholders entailing greater capital accumulation and greater capital formation generally resulting in greater wealth for the corporate entity.

Wealth maximization therefore implies ensuring that the corporation's capital investments and business operations expands, stocks value increase, and financial market performance is increased. Profit maximisation however is the increase in the returns to investment of shareholders are proprietors not necessarily resulting from business expansion. Profit maximisation therefore is a short term business objective while wealth maximisation is long term as it may sacrifice profits for wealth accumulation and wealth formation.

Wealth-profit argument

Wealth maximisation according to the business dictionary b(2013) is a process that increases the current net value of business or shareholder capital gains, with the objective of bringing in the highest possible return. While profit maximisation is the ability for company to achieve a maximum profit with low operating expenses. The wealth maximization strategy generally involves making sound financial investment decisions which take into consideration any risk factors that would compromise or outweigh the anticipated benefits while the profit maximisation strategy is cost reduction.

Wealth maximisation entails corporate benefit while profit maximization entails owners benefit. Wealth maximisation has long term financial and capital market benefits while profit maximisation has short term gains in immediate returns to investment. It is argued that management is really smart and intelligent and knows what is good and what is bad for the business however self-interest also drives management to maximize short-term profits even if that is detrimental to the long-term goal as they know that their salary and bonuses will be based on these short-term profits only. Wealth maximisation therefore ensures a more stable, larger market share, greater financial market performance in terms of value of stocks, more long term financial benefits for stockholders this therefore makes wealth maximisation of greater benefits compared to profit maximisation.

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 where, 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 funds 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 leverage.

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 payout ratio and the retained proportion of profits is known as retention ratio.

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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 maximization. Investment can be categorised into two 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

The Objective of Corporate Finance

Objectives of decisions 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 constituted three decisions :

- (a) Decision on investment
- (b) Decision of 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.

Other Objective of Corporate Finance

A firm is a group of claimants of shareholders, creditors, suppliers, customers and employees. The shareholders appoint a Board of Directors to see the functioning and directing the company. The directors will act in the interest of the claimant not act in their own interest. In corporate finance theory generally agrees that the objective of a firm is to maximize the profit and wealth maximization. Wealth maximization rules require managers to work towards a sustainable increase in the price of the firm's stock.

Van Horne.—We assume that the objective of the firm is to maximize its value to its stockholders.

Brealey and Myers : "Success is usually judged by value: The secret of success in financial management is to increase value."

In traditional corporate finance, the objective in decision making is to maximize the value of the firm.

Employees are often stockholders in many firms—firms that maximize stock price generally are profitable firms that can afford to treat employees well.

There are three principals in modern wealth maximization rule namely, (i) Profit maximization; (ii) Social welfare; (iii) Growth.

(i) **Profit maximization.**—Profit is the excess of revenue over expenses. Profit maximization requires manager to keep low expenses.

(ii) **Social welfare.**—Business persons are supposed to be socially responsible.

(iii) **Corporate growth.**

Importance of Corporate Finance

The importance of corporate finance can be classified as follows:—

- **Decision making.**—There are several decisions that have to be done on the basis of available capital and limited resources. If an organization has to start a new project, then it has to consider whether it would be financially viable and if it would yield profits. So while investing in a new project or a new venture, a company has to consider several things like availability of finances, the time taken for its completion, etc. and then makes decisions accordingly.
- **Research and development.**—In order to survive in a volatile market for a long duration, a business organization needs to continuously research the market and develop new products to appeal the consumers. It may even have to upgrade its old products to compete with new vendors in the market. Some companies employ people to conduct market surveys on a large scale; prepare questionnaire for consumers; do market analysis, while other may outsource this work to others. All these activities would require financial support.
- **Fulfilling long term and short term goals.**—Every organization has several long term goals in order to survive in the market. The short term goals may include paying the salaries of employees, managing the short term assets, acquiring corporate finances like bank drafts, trade credit from suppliers, purchase of raw materials for production etc. Some long term goals would include acquiring bank loans and paying them off; increasing the customer base for the company etc.
- **Depreciation of assets.**—When you invest in a new software or a new equipment, you would require to keep aside some amount to maintain it and upgrade it in the long run. Only then you could be assured that it would yield good results over a period of time. In the fast changing times of today, if this is not done, you might end up losing business if you do not have finances for it.
- **Minimizing cost of production.**—Corporate finance helps in minimizing the cost of production. With the rising cost of prices of raw materials and labour, the management has to come up with innovative measures to minimize the cost of production. In many organizations that spend a lot of money on large scale production, deploy professionals for this purpose. These people tend to buy quality products from vendors who offer it at lower possible rates. For example, a products-based software company might buy software from a vendor that sells it at a lower rate than an internationally acclaimed company selling the same thing.

- **Rising capital.**—When an organization has to invest a new venture, it is very important that it has to raise capital. This can be done by selling bonds and debentures, stocks of the company taking loans from the banks etc. All this can be done only by managing corporate finances in a proper manner.
- **Optimum utilization of resources.**—The resources available to organizations may be limited. But if they are utilized efficiently, they can yield good results. For example, a business organization needs to know the amount of money it can spend on its employees and how much hike should be given to them. The proper management of corporate finance would also help in utilizing its profits in such a manner that would help in increasing them; for example, investing in government bonds, keeping up with the latest technology trends to increase efficiency.
- **Efficient functioning.**—A smooth flow of corporate finance would enable businesses to function in a proper manner. The salaries of employees would be paid on time, loans would be cleared in time, purchase raw materials can be done when required, sales and promotion for existing products and launch of new products, etc.
- **Expansion and diversification.**—Before an organization decides to expand or diversify into a new arena, it has to consider various aspects like the capital available, risks involved, the amount to be invested for purchased of new equipment, etc. All this can be done by experts and this would be very beneficial for the organization.
- **Meeting contingencies.**—Running a business involves taking several risks. Not all risks can be foreseen. Although you can transfer some of these risks to third parties by buying an insurance policy, you cannot have every contingency covered by your insurer. You would have to keep some amount aside to tide over these situations.

Corporate finance plays a very important role in the overall functioning, growth and development of a business. In India, finance advisors help entrepreneurs and businesses by providing them with vital information through market research and analysis. This helps them to make decisions, expand their business, and survive in a competitive market in the long run. Therefore, the management of corporate finance is very important, for profitable as well as non-profitable organizations.