**Corporate Finance**

**Module 1-Introduction to Financial Management 4hrs CO1**

Meaning of Financial Management and areas of decision-making, Objectives of financial management–profit maximization and wealth maximization. Changing role of finance managers. Organization of finance function.

**Role of Financial Management**  
The role of financial management is very important as the following activities are influenced by financial management:

1. Size and composition of Fixed Assets (Fixed Capital decisions)
2. Size and composition of Current Assets (Working Capital Management decisions)
3. Financing decisions (Amount of Debt or Equity to be used)
4. Financing decisions (Amount of Long-term funds or Short-term funds to be used for financing)
5. All items in the Profit & Loss Account (sales expenses, distribution expenses, depreciation of the assets, etc.)

**Financial Decisions**  
Financial decisions are taken under financial management, and directly deal with raising and investing of funds (investment decisions), and distribution of profit earned among the stakeholders (dividend decisions).  
Financial decisions are of three types –  
I. Investment decisions  
II. Financing decisions  
III. Dividend decisions

**I. INVESTMENT DECISIONS**  
The decisions which involve the choice how the raised funds will be invested into short-term or long-term assets.  
Investment decision are of two types:

* Long-term investment decisions (also know as Fixed assets decisions or Capital budgeting decisions)
* Short term investment decisions (also known as Working Capital management decisions)

**Factors affecting long-term investment decisions**  
The Investment criteria involves:

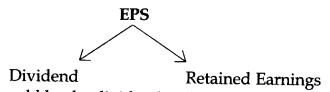
1. **Cash flows of the project.** The cash flows which a company expects from an investment decision should be carefully analysed before taking a Capital budgeting decision.  
   The Rate of return. The expected rate of return of the project should be taken into consideration before taking Capital budgeting decision.
2. **The investment criteria involved.** Financial managers have to carry out a number of calculations regarding cash flows, interest rates, rate of return etc. before taking the Investment decision. Various Capital budgeting techniques are used for the purpose of evaluating investment proposals.

**II. FINANCING DECISION**  
The decisions which involve the choice how the funds will be raised from various sources and simultaneous cost analysis of these sources of funds.  
The sources of finance are:

* Shareholders’ or Owners’ funds:  
  Equity Capital and Retained earnings
* Borrowed funds:  
  Debentures, Loans and other forms of Debts.

**Factors affecting financing decisions:**

1. **Cost.** Cheapest source of finance should be preferred. (Debt is generally cheaper than Equity)
2. **Risk.** Source involving less risk should be preferred. (Equity is less risky than Debt)
3. **Floatation cost.** If a source has high floatation cost it should be avoided (Equity has high floatation costs associated with it).
4. **Cash flow position.** The source of funds should also depend on the Cash flow position of  
   the firm. A company with healthy Cash flow can go for Debt as it can bear the fixed financial cost of interest on Debt.
5. **Fixed operating cost.** A company which has high fixed operating costs (like rent, salary, etc.) already runs high business risk. If such firm goes for Debt as source, it will add on financial risk (as Debt is risky).
6. **Control considerations.** A company having control considerations should go for Debt as a source of finance.
7. **State of Capital market.** When the Capital market is bullish or active (investors believe that the stock prices will increase), it is a good time for issuing Equity in order to have a good response from the investors. On the other hand, if the Capital market is bearish or sluggish (investors believe that stock prices will decrease) it is better not to issue Equity.  
   The company can opt for Debt as a source of funds.

**III. DIVIDEND DECISION**  
The part of profit which is distributed by the company to its shareholders is known as dividend.  
For a proper understanding:  
Profit before Interest and Tax —> PBIT …[Interest which is to be paid on borrowed money  
PBIT – Interest = PBT (Profit before tax)  
PBT – Tax = PAT (Profit after tax)  
*PATNo*.*ofShares* = EPS (Earning Per share)  
**EPS has two parts:**  
  
The decision of how much should be the dividend and how much should be retained is known as Dividend decision.

**Factors affecting Dividend decision:**

1. **Amount of Earnings.** Dividends paid by a company are dependent on the amount of earnings.
2. **Stability of earnings.** Apart from amount of earnings, stability of the earnings is as much important for paying good dividends.
3. **Stability of dividend.** A stable trend in payment of dividend boosts the confidence of investors and has a good impact on share prices.
4. **Growth opportunities.** Generally, companies having high growth opportunities tend to avoid paying high dividends, so that they can invest their retained earnings.
5. **Cashflow position.** In order to declare dividends a company should have decent amount of cash. So, a company with good Cash flow position can declare good dividend.
6. **Shareholders’ preference.** There are two types of shareholders. One, who want a fixed dividend (Preference dividend) and the others, who are ready to bear risk and want to have high returns (Equity dividend).
7. **Taxation Policy.** If tax on dividend is high, companies tend to pay lower dividend and vice-versa.
8. **Stock market reaction.** Increased dividends draw positive reaction from the stock market. However, if the dividends are lowered by a company it tends to have a bad impact on the share prices as their demand goes down.
9. **Access to Capital market.** Large credit-worthy companies have easy access to the capital market in terms of raising funds. These companies can keep less retained earnings and pay a higher dividend to strengthen the market price of their shares.
10. **Legal constraints.** Since the payment of dividend is connected with a large number of shareholders, it should be done within the legal framework and transparency.
11. **Contractual constraints.** Generally loan providing bodies ensure through contractual agreements that the borrowing company will be restricted in payment of dividends. This is done to provide financial protection to the lenders who may get in trouble in situation of bankruptcy of the borrower.

**Financial Planning**  
Financial planning is the process of estimating the requirement of funds by an organisation for its various needs and figuring out the sources of these funds.

**Objectives of Financial Planning**

* The first objective is to ensure availability of funds, as and when required.
* The second objective is to confirm that the funds raised are not in excess.

**Importance of Financial Planning**

1. **It helps in forecasting.** It helps in making correct assessment of future financial situations through proper forecasting.
2. **It helps in preparing for business shocks.** The future uncertainties of business can ruin the prospects of a business. Financial planning keeps the firm well prepared to face any business shocks.
3. **It helps in coordination of various business functions.** All the other business functions like marketing, purchase, production, etc. can be properly coordinated as a result of of proper financial planning.
4. **It helps in optimum utilization of resources.** Optimum utilisation of resources and efforts becomes possible through proper financial planning as the wastages and duplication of efforts are reduced.
5. **It acts as a link between present and future.** Financial planning is like a bridge between today and tomorrow, present and future. The financial requirement of present investment decision is fulfilled by future financing decisions.
6. **It helps in evaluation of actual performance.** The objectives of all the business units are clearly set through financial planning. That is why it is easy to do proper evaluation of actual performance by these units through financial planning.

**Capital Structure**  
It is the proportion of Debt and Equity in raising funds for doing business. In other words, it is the mixture of Owners’ funds and Borrowed funds.

**Factors affecting Capital Structure**

1. **Debt service coverage ratio: (DSCR)**  
   DCSR = *Profitaftertax*+*Depreciation*+*Interest*+*Non*−*cashExpencesPreferenceDividend*+*Interest*+*RepaymentObligation*  
   DSCR indicates ability of a firm to service its Debt. It is a better indicator than ICR.
2. **Interest coverage ratio (ICR)**  
   It is the number of times Earning Before Interest and Tax can cover the Interest on Debt taken by a firm.  
   It indicates the firm’s ability to serve the interest on Debt taken.  
   ICR = *EarningbeforeIntererstandTaxInterest*
3. **Cash flow position.** Debt should be taken only if Cash flow position of a company is good.
4. **Cost of Debt.** Debt can be taken if it is available at a lower interest rate.
5. **Cost of Equity.** Cost of Equity becomes high in case Debt is taken beyond a level. This happens due to the increased burden of Debt on equity shareholders who expect higher dividend.
6. **Capital structure of other companies.** A business firm may observe the capital structure (D/E ratio) of other companies in the same industry but should not blindly follow them. Deciding the capital structure of a company should be based upon its own strengths and weaknesses.
7. **Return on Investment.** When the return on investment is greater than the rate of interest, a company can increase its Debt to increase its earning per share (EPS).
8. **Tax rate.** With the increase in tax rate Debt becomes cheaper.
9. **Stock market conditions.** When market is bullish Equity is preferable, but when market is bearish Debt is a better choice.
10. **Floatation costs.** The costs of raising Debt and Equity are different. The high floatation costs of Equity in comparison to Debt make it a costlier source.
11. **Control considerations.** Too much of issuing of Equity may result in loss of control of management over the company.
12. **Regulatory framework.** In order to raise funds, the company should stay within the legal framework set by bodies like SEBI and RBI.
13. **Flexibility.** A company has only limited sources form where it can obtain Debt. In case it exhausts all the possible sources it will lose the flexibility to arrange further Debt.
14. **Risk consideration.** Debt is riskier though it is cheaper. A firm has to repay the principal amount as well as regular interest on it. It is bound to do so.

**Fixed Capital**  
Those assets which remain in business for more than a year constitute the Fixed capital of a business firm. The sources which finance Fixed capital are known as Long-term sources of funds. The decisions related to Fixed capital are also known as Fixed capital decisions or Capital budgeting decision.

**Importance of Fixed Capital Decisions**

1. **Long term growth.** They affect the long term growth of business as return on investment comes after a long time in future.
2. **Large amounts of funds involved.** The nature of Fixed capital decision is such (like investment in plant and machinery, etc.) that large amounts of funds need to be invested.
3. **Risk involved.** Since Fixed capital involves huge amounts of investments with no assured quick returns, it tends to become risky.
4. **Irreversible decision.** A company may have to incur heavy losses as reversing such decisions may lead to cancellation of the entire project.

**Factors affecting requirement of Fixed Capital**

1. **Nature of business.** Manufacturing requires more Fixed capital than trading business.
2. **Scale of operations.** A firm involving large scale business requires more Fixed capital.
3. **Choice of Technique.** Capital intensive business requires more Fixed capital than a labour intensive business.
4. **Upgradation of technology.** Business requiring frequent upgradations of technology requires more Fixed capital.
5. **Growth prospects.** Companies having higher growth prospects require more investment in Fixed capital.
6. **Diversification.** When a firm diversifies into new areas, its requirement of Fixed capital increases.
7. **Financing alternatives.** When business firms have an alternative of taking fixed assets on lease, they do not have to purchase fixed assets.
8. **Level of collaboration.** Fixed capital requirement of a firm becomes less if it gets into collaboration with another firm, as both the firms can share resources of each other.

**Working Capital**  
The capital needed by a business firm to meet its day to day operations is known as Working capital.  
Examples: Cash-in-hand, Raw materials, Prepaid expenses, Work-in-progress, Bills receivable etc.  
Such assets are also known as short term assets and they can be easily converted into cash within a period of one year.

**Factors affecting working capital requirements**

1. **Nature of business.** Manufacturing firms have more Working capital requirements than trading firms.
2. **Scale of operations.** Higher the scale of operations, more is the Working capital requirement.
3. **Business cycle.** More during recovery and boom, less during recession and depression.
4. **Seasonal factors.** Businesses that are seasonal in nature need more amount of working capital during the peak season.
5. **Production cycle.** Products having longer production cycle need more Working capital.
6. **Credit allowed.** More Working capital is required when credit is allowed by the business firm.
7. **Credit availed.** Less Working capital is required when credit is availed by the business firm.
8. **Availability of raw material.** If raw material is easily available, requirement is less, otherwise more.
9. **Growth prospects.** Higher the chances of growth, more will be the requirement.
10. **Level of competition.** Higher the level of competition among firms more will be their Working capital requirements.
11. **Inflation.** When prices rise (inflation), Working capital requirement also increases.

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The concept of strategic financial management has existed for a couple of decades now and shareholder wealth maximization has remained constant. This is not a fad but a raison d’etre for organizations across the globe. **In this article, we will have a closer look at why the maximization of shareholder wealth is a better objective than profit maximization**.

### The Pitfalls of Profit Maximization

Profit is calculated on a quarterly or an annual basis. This is almost no company in the world that calculates profit for a decade. This is the reason that profit maximization cannot be and should not be the objective of any business.

The very definition of profit maximization is such that it makes the organization short-sighted. The management becomes fixated with short-term numbers and makes decisions to ensure that they look good. However, short-term numbers can also be improved by unethical means. For instance, if a company pays its employees a lower salary as compared to its peers, it can improve its profitability numbers in the short run. However, in the long run, it will not be able to find a talented workforce and its future profits will suffer.

Wealth maximization changes the orientation of the company from the short term to the long term. Also, it needs to be noted that profit is not really an indisputable number. Companies can change their profit number by making changes to their accounting policy instead of improving the operations of the company. Also, the profits can be artificially inflated in the short run by making credit sales, a lot of which might end up being bad debts in the long run.

### Why Wealth Maximization is Important?

As mentioned above, the profit maximization objective leads companies towards making wrong decisions in the short run. This is the reason that shareholder wealth maximization can be considered to be a better objective. The wealth of the company is the sum of the present value of the discounted cash flow which will accrue to the company over a period of time. Hence, in order to maximize the shareholder’s value, the company has to maximize its cash flow. Cash flow, unlike profit, cannot be manipulated. Also, the firm is considering the sum of cash flow over a period of years. This is the reason that the company is forced to think about the long term. Value destroying decisions that create profit in the short run, but destroy value, in the long run, will be flagged if decisions are taken based on wealth maximization philosophy.

### What about the Other Stakeholders?

The shareholder’s wealth maximization philosophy has faced a lot of criticism. This is because the critics believe that the interests of the shareholders are given priority over the interests of other stakeholders because of this model. Hence, they believe that the objective of the firm should be stakeholder value maximization. This will ensure that the employees, suppliers, debtors, and other stakeholders of the firm do not feel neglected. However, the policy of shareholder wealth maximization does not conflict with the policy of stakeholder’s wealth maximization. It needs to be understood that the wealth created for the stakeholders needs to be optimized whereas for shareholders, it needs to be maximized.

Consider a case where a company is trying to maximize customer value or employee value. Customer value can be maximized when the company starts giving away goods for free or even start paying the customers to use their goods! However, this will not be sustainable in the long run since the company will go bankrupt if it continues doing this for some time. Similarly, if the company starts maximizing employee value, then they will have to give huge sums of money to all their employees. Once again, this would make the system unsustainable as labor costs will go through the roof.

The fact of the matter is that it is impossible to maximize the value for other stakeholders. Hence, for them, the value needs to be optimized. This means that the stakeholders should be given a better deal than the competition is offering. Hence, employees must be paid more than the competition and customers must have to pay less than what they would have paid to the competition. If the firm optimizes the value creation for other stakeholders, it automatically maximizes the value for shareholders. This is because shareholders get the residual value and the residual value can be maximized if all the other stakeholders are paid fairly and the operations are run in an efficient manner.

### The Conclusion

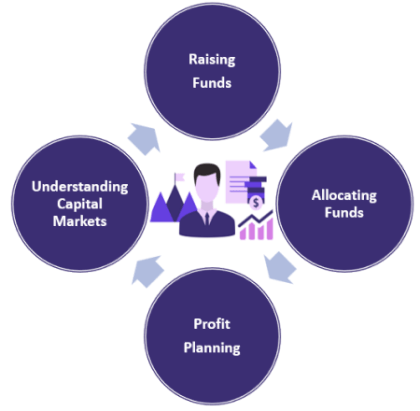
The bottom line is that shareholder wealth maximization is not a selfish objective. Instead, it is an objective which sums up the well-being of all the parties involved. Hence, it is likely to stay for a long time and all the other objectives of strategic finance must be built using this objective as the base.

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**A financial manger is a person who takes care of all the important financial functions of an organization**. The person in charge should maintain a far sightedness in order to ensure that the funds are utilized in the most efficient manner.

His/Her actions directly affect the Profitability, growth and goodwill of the firm.

**Following are the main functions of a Financial Manager:**



### Raising of Funds

In order to meet the obligation of the business it is important to have enough cash and liquidity. A firm can raise funds by the way of equity and debt. It is the responsibility of a financial manager to decide the ratio between debt and equity. It is important to maintain a good balance between equity and debt.

### Allocation of Funds

Once the funds are raised through different channels the next important function is to allocate the funds. The funds should be allocated in such a manner that they are optimally used. In order to allocate funds in the best possible manner the following point must be considered

* + The size of the firm and its growth capability
  + Status of assets whether they are long-term or short-term
  + Mode by which the funds are raised

These financial decisions directly and indirectly influence other managerial activities. Hence formation of a good asset mix and proper allocation of funds is one of the most important activity

### Profit Planning

Profit earning is one of the prime functions of any business organization. Profit earning is important for survival and sustenance of any organization. Profit planning refers to proper usage of the profit generated by the firm.

Profit arises due to many factors such as pricing, industry competition, state of the economy, mechanism of demand and supply, cost and output. A healthy mix of variable and fixed factors of production can lead to an increase in the profitability of the firm.

Fixed costs are incurred by the use of fixed factors of production such as land and machinery. In order to maintain a tandem it is important to continuously value the depreciation cost of fixed cost of production. An opportunity cost must be calculated in order to replace those factors of production which has gone thrown wear and tear. If this is not noted then these fixed cost can cause huge fluctuations in profit.

### Understanding Capital Markets

Shares of a company are traded on stock exchange and there is a continuous sale and purchase of securities. Hence a clear understanding of capital market is an important function of a financial manager. When securities are traded on stock market there involves a huge amount of risk involved. Therefore a financial manger understands and calculates the risk involved in this trading of shares and debentures.

**Its on the discretion of a financial manager as to how to distribute the profits**. Many investors do not like the firm to distribute the profits amongst share holders as dividend instead invest in the business itself to enhance growth. The practices of a financial manager directly impact the operation in capital market.

[**https://www.managementstudyguide.com/role-of-financial-manager.htm**](https://www.managementstudyguide.com/role-of-financial-manager.htm)

**Organization of the Finance Functions**  
   
Today, finance function has obtained the status of a science and an art. As finance function has far reaching significance in overall management process, structural organization for further function becomes an outcome of an important organization problem. The ultimate responsibility of carrying out the finance function lies with the top management. However, organization of finance function differs from company to company depending on their respective requirements. In many organizations one can note different layers among the finance executives such as Assistant Manager (Finance), Deputy Manager (Finance) and General Manager (Finance). The designations given to the executives are different. They are  
   
Chief Finance Officer (CFO)  
   
Vice-President (Finance)  
   
Financial Controller  
   
General Manager (Finance)  
   
Finance Officers  
   
Finance, being an important portfolio, the finance functions is entrusted to top management. The Board of Directors, who are at the helm of affairs, normally constitutes a ‘Finance Committee’ to review and formulate financial policies. Two more officers, namely ‘***treasurer’*** and ‘***controller’*** – may be appointed under the direct supervision of CFO to assist him/her. In larger companies with modern management, there may be Vice-President or Director of finance, usually with both controller and treasurer. The organization of finance function is portrayed below:

Diagram

Description automatically generated  
  
It is evident from the above that Board of Directors is the supreme body under whose supervision and control Managing Director, Production Director, Personnel Director, Financial Director, Marketing Director perform their respective duties and functions. Further while auditing credit management, retirement benefits and cost control banking, insurance, investment function under treasurer, planning and budgeting, inventory management, tax administration, performance evaluation and accounting functions are under the supervision of controller.

**Meaning of Controller and Treasurer**

The terms ‘controller’ and ‘treasurer’ are in fact used in USA. This pattern is not popular in Indian corporate sector. Practically, the controller / financial controller in India carried out the functions of a Chief Accountant or Finance Officer of an organization. Financial controller who has been a person of executive rank does not control the finance, but monitors whether funds so augmented are properly utilized. The function of the treasurer of an organization is to raise funds and manage funds. The treasures functions include forecasting the financial requirements, administering the flow of cash, managing credit, flotation of securities, maintaining relations with financial institutions and protecting funds and securities. The controller’s functions include providing information to formulate accounting and costing policies, preparation of financial reports, direction of internal auditing, budgeting, inventory control payment of taxes, etc. According to Prof. I.M. Pandey, while the controller’s functions concentrate the asset side of the balance sheet, the treasurer’s functions relate to the liability side.