1 INTRODUCTION TO CORPORATE FINANCE

INTRODUCTION :

The term finance is related to money and money management. It is related to inflow and outflow of money. Success of any business organisation depends upon the efficiency with which it is able to generate and use funds.

Henry Ford righty said, " Money is an arm or leg - use it or lose it." This statement clearly brings out the significance of finance for the success of a business.

1.1 CORPORATE FINANCE : MEANING

Corporate finance deals with the raising and using of finance by a corporation. It deals with financing the activities of the corporation, capital structuring and making investment decisions.

MEANING : DEFINITION

Henry Hoagland expresses the view that "corporate finance deals primarily with the acquisition and use of capital by business corporation."

The term corporate finance also includes financial planning, study of capital market, money market and share market. It also covers capital formation and foreign capital. Even financial organisations and banks play vital role in corporate financing.

The finance manager of any corporation has to ensure that -

a) the firm has adequate finance.
b) they are using the right source of funds that have minimum cost.
c) the firm utilises raised funds effectively.
d) they are generating maximum returns for it's owners.

The following two decisions are the basis of corporate finance.

1) **Financing Decision :** The business firm has access to capital market to fulfill it's financial needs. The firm has multiple choices of sources of financing. The firm can choose whether it wants to raise equity capital or debt capital. Firm can even opt for bank loan, public deposits, debentures etc. to raise funds. The finance manager ensures that the firm is well capitalised i.e. they have right amount of capital and that the firm has right combination of debt and equity.

> *Capital market is a market for long term debt instruments and equity shares. In this market, equity and debt instruments are issued and traded.*

2) **Investment Decision :** Once the business firm has gained access to capital, the finance manager has to take decision regarding the use of the funds in systematic manner so that it will bring maximum return for its owners. For this, the firm has to take into consideration the cost of capital. Once they know the cost of capital, firm can deploy or use the funds in such a way that returns are more than cost of capital.

> *Cost of capital is minimum return expected by it's investors.*

Finding investments and deploying them successfully in the business is known as investing decision. It is also called as 'capital budgeting'.

1.2 IMPORTANCE OF CORPORATE FINANCE :

In the functional management of business enterprise, importance is given to production, finance, marketing and personnel activities. Among all these activities, utmost importance is given to financial activities. The importance of corporate finance may be discussed as follows -

1. **Helps in decision making :** Most of the important decisions of business enterprise are determined on the basis of availability of funds. It is difficult to perform any function of business enterprise independently without finance.

   Every decision in the business is needed to be taken keeping in view of it's impact on profitability. There may be number of alternatives but the management is required to select the best one which will enhance profitability. Business organisation can give green signal to the project only when it is financially viable. Thus corporate finance plays significant role in decision making process.

2. **Helps in Raising Capital for a project :** Whenever a business firm wants to start a new venture, it needs to raise capital. Business firm can raise funds by issuing shares, debentures, bonds or even by taking loans from the banks.

3. **Helps in Research and Development :** Research and Development must be undertaken for the growth and expansion of business. Detailed technical work is essential for the execution of projects. Research and Development is lengthy process and therefore funds have to be made available through out the research work. This would require continuous financial support.

   Many a time, Company has to upgrade its old product or develop new product to attract the consumers. For this company has to conduct survey, market analysis, etc. which again requires financial support.

4. **Helps in smooth running of business firm :** A smooth flow of corporate finance is needed so that salaries of employees are paid on time, loans are cleared on time, raw material is purchased whenever required, sales promotion of existing products is carried out smoothly and new products can be launched effectively.

5. **Brings co-ordination between various activities :** Corporate finance plays significant role in control and co-ordination of all activities in an organisation. For e.g. Production will suffer, if finance department does not provide adequate finance for the purchase of raw materials and meeting other day-to-day financial requirements for smooth running of production unit. Due to this, sales will also suffer and consequently the income of concern as well as rate of profit will be affected. Thus efficiency of every department depends upon the effective financial management.

6. **Promotes expansion and diversification :** Modern machines and modern techniques are required for expansion and diversification. Corporate finance provides money to purchase modern machines and technologies. Therefore finance becomes mandatory for expansion and diversification of a company.

7. **Managing Risk :** Company has to manage several risks, such as sudden fall in sales, loss due to natural calamity, loss due to strikes, etc. Company needs financial aid to manage such risks.

8. **Replace old assets :** Assets such as plant and machinery become old and outdated over the years. They have to be replaced by new assets. Finance is required to purchase new assets.

9. **Payment of dividend and interest :** Finance is needed to pay dividend to shareholders, interest to creditors, banks, etc.

10. **Payment of taxes/fees :** Company has to pay taxes to Government such as Income Tax, Goods and Service Tax (GST) and fees to Registrar of Companies on various occasions. Finance is needed for paying these taxes and fees.

1.3 CAPITAL REQUIREMENTS :

When a business entrepreneur conceives an idea of setting up a business enterprise, the commercial viability of the idea is investigated. Once the entrepreneur is satisfied with the feasibility of the project, serious steps are taken to start the project. The first and foremost step is to take decision on the amount of capital requirement to start and run the business. This task has to be performed with utmost care. Therefore financial plan should be drafted keeping in mind present and future requirement of the business. Thus while deciding about the volume of capital requirement, an entrepreneur has to take into consideration - fixed capital requirement and working capital requirement. We shall now discuss these capital requirements in detail.

Financial plan refers to assessment of financial requirement and arranging sources of capital.

(A) Fixed Capital : Fixed capital is the capital which is used for buying fixed assets which are used for a longer period of time in the business. These assets are not meant for resale.

In simple words fixed capital refers to capital invested for acquiring fixed assets. It stays in the business for long period almost permanently. Examples of fixed capital are - capital used for purchasing land and building, furniture, plant and machinery etc. Such capital is required usually at the time of establishment of a new company. However, existing companies may also need such capital for their expansion and development, replacement of equipments, etc.

Initial planning of fixed capital requirement is made by company's promoters. For this, they first prepare a list of fixed assets needed by the company and cost of these assets is estimated. They collect information regarding price of land, cost of construction of building, cost of plant and machinery, etc. The cost of different fixed assets is calculated and the resulting figure would be the total of fixed capital requirement of a new firm.

In recent years, estimating fixed capital requirement has assumed great importance particularly because of modern industrial processes which require increased use of heavy and automated machineries.

An entrepreneur obtains funds for the purchase of fixed assets from capital market. Funding can come from issue of shares, debentures, bonds or obtaining even long term loans.

Factors affecting fixed capital requirement :

1. **Nature of business :** Manufacturing industries and public utilities have to invest huge amount of funds to acquire fixed assets. While Trading business may not need huge investments in fixed assets.
2. **Size of business :** Where a business firm is set up to carry on large scale operations, its fixed capital requirements are likely to be high. It is because most of their production processes are based on automatic machines and equipments.
3. **Scope of business :** There are business firms which are formed to carry on production or distribution on a large scale. Such businesses would require more amount of fixed capital.
4. **Extent of lease or rent :** If entrepreneur decides to acquire assets on lease or on rental basis, less amount of funds for fixed assets will be needed for the business.

> ***Lease :*** *A contract by which one person grants possession of some of his property especially land, building or machinery to another for a certain period of time.*

5. **Arrangement of sub-contract :** If the business wants to sub-contract some processes of production to others, limited assets are required to carry out the production. It would minimise fixed capital requirement of business.
6. **Acquisition of old assets :** If old equipments and plants are available at low prices, then it would reduce the need for investment in fixed assets.
7. **Acquisition of assets on concessional rate :** With the view to foster industrial growth at regional level, the government may provide land and building, materials at concessional rates. Plants and equipments may also be made available on instalment basis. Such facilities will reduce the requirement of fixed assets.
8. **International conditions :** This factor is very significant particularly in large organisations carrying business on international level. For example : companies expecting war, may decide to invest large funds to expand fixed assets before there is shortage of materials.

9. **Trend in economy :** If the future of the company is anticipated to be bright, it gives green signal to business entrepreneur to carry out all sorts of expansion of business firm. In that case, large amount of funds are invested in fixed assets so as to reap the benefits in future.

10. **Population trend :** When the population is increasing at high rate, certain manufactures find this as an opportunity to expand business. For example- automobile industry, electronic goods manufacturing industry, ready-made garments, etc. which necessitates huge amount of fixed capital.

11. **Consumer preference :** Industries providing goods and services which are in good demand, will require large amount of fixed capital. For example - Mobile phone manufactures as well as mobile network providers.

12. **Competitive factor :** This factor is prime element in decision making regarding fixed capital requirements. If one of the competitor's shifts to automation, the other companies in the same line of activity, will be compelled to follow that competitor.

(B) Working Capital

Working capital is the capital which is used to carry out the day to day business activities. After estimating fixed capital requirement of the business firm, it is necessary to estimate the amount of capital, that would be needed to ensure smooth functioning of the business firm. A business firm requires funds to store adequate raw material in stock. A firm would need capital to maintain sufficient stock of finished goods. In actual practice goods are sold out in cash or on credit. Goods sold on credit do not fetch cash immediately. Firm will have to arrange for funds till the amount is collected from the debtors. Cash is also required to pay overheads. Since uncertainty is always a feature of business, some excess cash also should be maintained to meet unexpected expenses.

> ***Overheads :*** *Overhead means indirect cost or expenses required to run a business. Overhead expenses include accounting fees, advertising, insurance, interest, legal fees, rent, repairs, taxes, telephone bills, travel expenditure, etc.*

Thus, a business firm will have to arrange capital for the following :

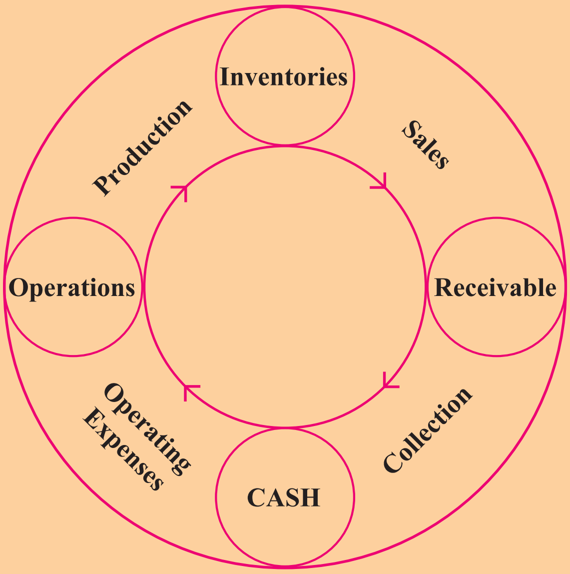
a) For building up inventories

b) For financing receivables

c) For covering day-to-day operating expenses.

The capital invested in these assets is referred to as 'Working capital'. The concept of working capital is viewed differently by leading authorities. Some authorities consider working capital as equivalent to excess of current assets over current liabilities. Gerstenbergh, defines it as, "The excess of current assets over current liabilities." This approach refers to 'Net Working Capital'. Gerstenbergh does not call it as working capital. He prefer to call it as 'circulating capital'. Other authorities viewed working capital equivalent to current assets. According to J. S. Mill, "The sum of current assets is working capital." This approach has broader application. It takes into consideration all current assets, of the company. It refers to 'Gross Working Capital'.

Additional information :



Cycle flow of Working Capital

Cyclical flow of working capital :

A business firm needs fund to finance it's working capital needs. Prominent share of this fund is used to buy raw materials and remaining part is kept available to pay wages and expenditures. Thus the working capital which was in the form of cash is converted into inventories. Raw materials are converted into work-in-process and then to finished goods. With the sale of finished goods they turn into account receivables, presuming the goods are sold on credit basis. Normally account receivables have maturities of specific days after billing date. Collection of the receivable brings back the cycle to cash.

A part of cash may be used to pay creditors, pay income tax and declare dividend and rest of it is put into circulation again.

Factors affecting working capital requirement :

There is no precise standards to measure working capital adequacy. Management has to determine the size of working capital in the light of certain aspects of business firm and economic environment within which the firm operates.

1. Nature of business :

Firms engaged in manufacturing essential products of daily consumption would need relatively less working capital as there would be constant and sufficient cash inflow in the firm to take care of liabilities. Likewise public utility concerns have to maintain small working capital because of continuous flow of cash from their customers.

> ***Public utility concern :*** *These concerns provide services such as transport, gas, electricity, etc.*

On the contrary, if the business is dealing in luxurious products, it requires huge amount of working capital, as sale of luxurious items are not frequent.

Trading/merchandising firms which are concerned with distribution of goods have to carry big inventories of goods to meet customer's demand and have to extend credit facilities to attract customers. Hence they need large amount of working capital.

> *Merchandising firms are those which are concerned with buying and selling of goods, either as wholesaler or retailer, without altering the physical form of goods.*

2. Size of business :

The size of business also affects the requirement of working capital. A firm with large scale operations will require more working capital.

3. **Volume of sales :**

   This is the most important factor affecting size of working capital. The volume of sales and size of working capital are directly related with each other. If volume of sales increases, there is an increase in the amount of working capital and vice a versa.

4. **Production cycle :**

   The process of converting raw material into finished goods is called production cycle. If the period of production cycle is longer, then firm needs more amount of working capital. If manufacturing cycle is short, it requires less working capital.

5. **Business cycle :**

   When there is a boom in the economy, sales will increase. This will lead to increase in investment in stocks. This requires additional working capital.

   During recession, sales will decline and hence the need of working capital will also decline.

6. **Terms of purchases and sales :**

   If the firm does not get credit facility for purchases but adopts liberal credit policy for its sales, then it requires more working capital.

   On the other hand if credit terms of purchases are favourable and terms of credits sales are less liberal, then requirement of cash will be less. Thus working capital requirement will be reduced.

7. **Credit control :**

   Credit control includes the factors such as volume of credit sales, the terms of credit sales, the collection policy, etc. If credit control policy is sound, it is possible for the company to improve it's cash flow. If credit policy is liberal, it creates a problem of collection of funds. It can increase possibility of bad debts. Therefore a firm requires more working capital.

   The firm making cash sales requires less working capital.

8. **Growth and Expansion :**

   The working capital requirement of a firm will increase with growth of a firm. A growing company needs funds continuously to support large scale operations.

9. **Management ability :**

   The requirement of working capital is reduced if there is proper co-ordination between production and distribution of goods. A firm stocking on heavy inventory calls for higher level for working capital.

10. **External factors :**

    If financial institutions and banks provide funds to the firm as and when required, the need for working capital is reduced.

1.4 CAPITAL STRUCTURE :

A company can raise its capital from different sources. i.e. owned capital or borrowed capital or both. The owned capital consists of equity share capital, preference share capital, reserves and surplus. On the other hand, borrowed sources are debentures, loans, etc. A combination of different sources are used in capital structure. It is nothing but 'security mix.'

Capital structure means 'mix up of various sources of funds in desired proportion'. To decide capital structure means, to decide upon the ratio of different types of capital.

1.4.1 Definition

R. H. Wessel : " The long term sources of funds employed in a business enterprise".

John Hampton : "A firm's capital structure is the relation between the debt and equity securities that makes up the firm's financing of it's assets".

Thus capital structure is composed of owned funds and borrowed funds. Owned funds includes share capital, free reserves and surplus, whereas, borrowed funds represent debentures, Bank loans and long term loans provided by financial institutions.

Additional information :

Principles of Capital Structure : Two basic principles are observed while taking decision about capital structure.

(1) The ratio of 'debt to equity' should always be geared to the degree of stability of earning.

(2) The capital structure must be balanced with adequate 'equity cushion' to absorb the shocks of the business cycle and to afford flexibility.

1.4.2 Components of Capital Structure :

There are four basic components of capital structure. They are as follows :

(1) Equity share capital : It is the basic source of financing activities of business. Equity shares are shares which get dividend and repayment of capital after it is paid to preference shares. They own the company. They bear ultimate risk associated with ownership. They carry dividend at fluctuating rate depending upon the profits.

(2) Preference share capital : Preference shares carry preferential right as to payment of dividend and have priority over equity shares for return of capital when the company is liquidated. These shares carry dividend at fixed rate.

(3) Retained earnings : It is internal source of financing. It is nothing but ploughing back of profit.

(4) Borrowed capital : It comprises the following :

a) Debenture :

It is acknowledgement of loans raised by company. Company has to pay interest at an agreed rate.

b) Term loan :

Term loans are provided by bank and other financial institutions. They carry fixed rate of interest.

To understand the above concept, we shall consider following Balance sheet and calculate the values :

Balance sheet of ABC Company Ltd. as on 31st March, 2019

Liabilities	Amount ₹	Assets	Amount ₹
Share Capital		**Fixed Assets**	
10,000 equity shares of ₹10 each fully paid	1,00,000	Building	4,00,000
		Plant and Machinery	2,00,000
5,000 preference shares of ₹100 each fully paid.	5,00,000	**Current Assets**	
		Sundry Debtors	1,00,000
Reserves and Surplus	50,000	Inventories	50,000
Liabilities		Cash in hand	10,000
1000, 10% Debentures of ₹ 100 each fully paid	1,00,000	Cash at bank	40,000
Sundry creditors	30,000		
Bills payable	20,000		
	8,00,000		**8,00,000**

Capital Structure = Equity Share Capital + Pref. Share Capital + Reserves + Debentures

= 1,00,000 + 5,00,000 + 50,000 + 1,00,000

= 7,50,000

Activity : Visit website of any public limited company and find out details of its capital structure.

1.5 Distinction :

Points	Fixed capital	Working capital
1) Meaning	Fixed capital refers to any kind of physical asset i.e. fixed assets.	Working capital refers to the sum of current assets.
2) Nature	It stays in the business almost permanently.	Working capital is circulating capital. It keeps changing.
3) Purpose	It is invested in fixed assets such as land, building, equipments, etc.	Working capital is invested in short term assets such as cash, account receivable, inventory, etc.
4) Sources	Fixed capital funding can come from selling shares, debentures, bonds, long term loans, etc.	Working capital can be funded with short term loans, deposits, trade credit, etc.
5) Objectives of Investors	Investors invest money in fixed capital hoping to make future profit.	Investors invest money in working capital for getting immediate returns.
6) Risk	Investment in fixed capital implies more risk.	Investment in working capital is less risky.

SUMMARY

- Corporate finance deals with the acquisition and use of capital by business corporation.
- Fixed capital is that portion of capital which is invested in fixed assets such as land, building, equipments, etc.
- Working capital refers to a firm's investment in current assets such as cash, account receivable and inventories.
- Capital structure refers to the proportion of different sources of funds raised by a firm for long term finance.

EXERCISE

Q.1 A) Select the correct answer from the options given below and rewrite the statements.

1. .... is related to money and money management.

   a) Production b) Marketing c) Finance

2. Finance is the management of .... affairs of the company.

   a) monetary b) marketing c) production

3. Corporation finance deals with the acquisition and use of .... by business corporation.

   a) goods b) capital c) land

4. Company has to pay .... to government.

   a) taxes b) dividend c) interest

5. .... refers to any kind of fixed assets.

   a) Authorised capital b) Issued capital c) Fixed capital

6. .... refers to the excess of current assets over current liabilities.

   a) Working capital b) Paid-up capital c) Subscribed capital

7. Manufacturing industries have to invest .... amount of funds to acquire fixed assets.

   a) huge b) less c) minimal

8. When the population is increasing at high rate, certain manufacturers find this as an opportunity to .... business.

   a) close b) expand c) contract

9. The sum of all .... is gross working capital.

   a) expenses b) current assets c) current liabilities

10. .... means mix up of various sources of funds in desired proportion.

    a) Capital budgeting b) Capital structure c) Capital goods

B) Match the pairs.

Group 'A'		Group 'B'	
a)	Capital budgeting	1)	Sum of current assets
b)	Fixed capital	2)	Deals with acquisition and use of capital
c)	Working capital	3)	Fixed liabilities
d)	Capital structure	4)	Sum of current liabilities
e)	Corporate finance	5)	Fixed assets
		6)	Investment decision
		7)	Financing decision
		8)	Deals with acquisition and use of assets
		9)	Mix up of various sources of funds
		10)	Product mix

C) Write a word or a term or a phrase which can substitute each of the following statements.

1. A key determinant of success of any business function.
2. The decision of finance manager which ensures that firm is well capitalised.
3. The decision of finance manager to deploy the funds in systematic manner.
4. Capital needed to acquire fixed assets which are used for longer period of time.
5. The sum of current assets.
6. The excess of current assets over current liabilities.
7. The process of converting raw material into finished goods.
8. The boom and recession cycle in the economy.
9. The ratio of different sources of funds in the total capital.
10. The internal source of financing.

D) State whether the following statements are true or false.

1. Finance is related to money and money management.
2. Business firm gives green signal to the project only when it is profitable.
3. Corporate finance brings co-ordination between various business activities.
4. Fixed capital is also referred as circulating capital.
5. Working capital stays in the business almost permanently.
6. The business will require huge funds, if assets are acquired on lease basis.
7. The business dealing in luxurious products will require huge amount of working capital.

8. A firm with large scale operations, will require more working capital.
9. Liberal credit policy creates a problem of bad debts.
10. Financial institutions and banks cater to the working capital requirement of business.

E) Find the odd one.

1. Land and Building, Plant and Machinery, Cash.
2. Debenture Capital, Equity Share Capital, Preference Share Capital.
3. Fixed Capital, Capital Structure, Working Capital.

F) Complete the sentences.

1. Initial planning of capital requirement is made by ....
2. When there is boom in economy, sales will ....
3. The process of converting raw material into finished goods is called ....
4. During recession period sales will ....

G) Select the correct option from the bracket.

Group 'A'		Group 'B'	
a)	Financing decision	1)	....
b)	....	2)	Longer period of time.
c)	Investment decision	3)	....
d)	....	4)	Circulating capital
e)	Combination of various sources of funds	5)	....

(To have right amount of capital, Deploy funds in systematic manner, Fixed capital, Working capital, Capital structure)

H) Answer in one sentence.

1. Define corporate finance.
2. What is fixed capital ?
3. Define working capital.
4. What is production cycle ?
5. Define capital structure.

I) Correct the underlined word/s and rewrite the following sentences.

1. Finance is needed to pay <u>dividend</u> to debentureholders.
2. When there is <u>recession</u> in economy sales will increase.
3. <u>Share</u> is an acknowledgement of loan raised by company.
4. <u>Equity</u> shares carry dividend at fixed rate.

Q.2 Explain the following terms / concepts.

1. Financing decision
2. Investment decision
3. Fixed capital
4. Working capital

Q.3 Study the following case / situation and express your opinion.

(1) The management of 'Maharashtra State Road Transport Corporation', wants to determine the size of working capital.

a. Being a public utility service provider, will it need less working capital or more ?

b. Being a public utility service provider, will it need more Fixed Capital ?

c. Give one example of public utility service that you come across on day-to-day basis.

(2) A company is planning to enhance it's production capacity and is evaluating the possibility of purchasing new machinery whose cost is ₹ 2 crore or has alternative of machinery available on lease basis.

a. What type of asset is machinery ?

b. Capital used for purchase of machinery is fixed capital or working capital ?

c. Does the size of a business determine the fixed capital requirement ?

Q.4 Distinguish between the following.

1. Fixed Capital and Working Capital.

Q.5 Answer in brief.

1. Define capital structure and state it's components.
2. State any four factors affecting fixed capital requirement.
3. What is corporate finance and state two decisions which are basis of corporate finance.

Q.6 Justify the following statements.

1. The firm has multiple choices of sources of financing.
2. There are various factors affecting the requirement of fixed capital.
3. Fixed capital stays in the business almost permanently.
4. Capital structure is composed of owned funds and borrowed funds.
5. There are various factors affecting the requirement of working capital.

Q.7 Answer the following questions.

1. Discuss the importance of corporate finance.
2. Discuss the factors determining working capital requirement.

❑❑❑