Foundations of Accounting & Finance

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Week - 01

Lecture - 02

Introduction to Corporate Finance

Corporate Finance: Two Basic Functions

Typical corporate finance involves two core functions:

1. Sourcing money at the lowest possible cost.
2. Investing that money in an option that offers the highest possible return, considering your risk appetite.

When considering risk, it is crucial to understand why risk appetite, specifically the risk-taking ability is significant. Investing money entails potential returns but also the risk of losses. For example, one might decide to gamble or bet all borrowed money on a horse race, indicating a high-risk appetite. However, such high-risk actions also entail a high probability of failure. Consequently, the cost of borrowing increases when engaging in such high-risk endeavours.

Let us illustrate with an example:

Imagine I borrow money with the intention of investing in a very safe asset. The lender understands that investing in this safe asset will likely generate returns, allowing me to repay the borrowed amount. Consequently, the lender is confident in lending me the money, assuming honest business intentions.

Given this scenario, the lender offers me money at a low-interest rate, content with the assurance of repayment. However, instead of investing in the safe asset as promised, I choose to use the borrowed money to bet in a horse race.

The lender is aware of the increased risk associated with this choice. If I lose the bet, I may not be able to repay the borrowed amount. Consequently, the lender charges a higher interest rate to compensate for the elevated risk.

In summary, when discussing corporate finance, the primary objectives are sourcing money at the lowest cost and investing in options that offer the best possible return, considering risk appetite or risk ability.

Role of Finance Manager or Chief Financial Officer (CFO)

The primary duty of a CFO is twofold:

- to source money at the lowest possible cost and
- to invest in options that offer the best possible return.

However, the complexity and significance of the CFO's role are evident when considering the challenges, they face. Sourcing money at the lowest cost is inherently challenging. Moreover, investing money in options that not only yield the best possible return but also ensuring timely returns adds another layer of complexity to the CFO's responsibilities. Timely returns are crucial, especially when considering obligations such as repaying borrowed funds within specific timelines. Lastly, the question that is even more difficult is for the CFO to decide on the combination of source of borrowing and the quantum of borrowing or financing from each source. Here an important point to note is that the cost of each source of financing is different and the cost will further differ with combinations.

For instance, if an investment option promises returns only after three years, but the CFO needs to repay borrowed funds the following year, this situation leads to a vicious cycle of borrowing to meet repayment obligations, highlighting the importance of effective asset liability management (ALM) to avoid such mismanagement scenarios.

In essence, sourcing and investing are the two core aspects of corporate finance, and the role of the CFO encompasses navigating these challenges while ensuring optimal financial outcomes for the organization.

Sourcing and Investing

When discussing sourcing money, it's essential to explore the various options available. Borrowing is one common method, but it's not the only option. Alternatives include raising equity in the market through share issuance, a topic we will delve into further as we progress. Even within borrowing, there exist numerous avenues. Borrowing can take the form of issuing debentures or bonds, obtaining loans from banks or financial institutions, or even borrowing from international institutions. For instance, consider SoftBank, a Japanese company known for lending money to start ups in India. Additionally, funding can be raised through venture capital or other forms of financing.

Regarding investment options, there are countless possibilities. It's crucial to carefully consider the chosen investment option before raising funds, as this decision will impact the interest rate on borrowing. Ultimately, sourcing funds involves exploring multiple avenues and finding the most suitable combination of sources to meet financial objectives.

Time Value of Money

In corporate finance, along with sourcing and investing, it's crucial to consider the concept of the time value of money. This principle emphasizes that the value of money today is greater than its value in the future.

To illustrate, suppose you have 100 rupees today, and you use it to purchase a product. In a year's time, to buy the same product, you would likely need to spend more than 100 rupees due to factors such as inflation. This highlights the diminishing value of money over time.

Consider an example: If you invest 100,000 dollars today and receive a return of 110,000 dollars after 5 years, it may seem like a profitable investment at first glance. However, when considering the time value of money, we need to assess whether the 110,000 dollars that will be received after 5 years is worth more or less than 100,000 dollars today.

Given a depreciation rate of 5 percent per year, the value of money depreciates by roughly 25 percent over 5 years. Therefore, the 110,000 dollars received after 5 years would be worth significantly less than 100,000 dollars today.

Understanding the time value of money is essential when making investment decisions. While various scientific methods exist to calculate these rates, the key takeaway is to consider the time value of money as it is crucial when making sourcing and investing decisions in corporate finance.

Other Finance Verticals

In addition to sourcing funds at the lowest cost and investing with the best possible return while considering the time value of money, corporate finance encompasses various other financial verticals. Let's explore some of these:

- **Investment Management:** Investment management involves allocating funds into investment options such as, stocks, real estate, and other investment avenues. The primary goal remains the same—to achieve the best possible return on investments.
- **Investment Banking:** Investment banking involves financial services such as underwriting, mergers and acquisitions, and advisory services.
- **Valuation:** Valuation entails assessing the present and future value of investments.
- **Derivatives:** Derivatives are financial instruments used for hedging risks rather than direct investment.

Overall, these financial verticals revolve around the fundamental principles of corporate finance: sourcing funds at the lowest cost and investing them in options that offer the best possible returns.

Summary

In summary, this course encompasses three main areas: financial accounting, cost accounting, and corporate finance. Here's a breakdown of the course content:

1. **Financial Accounting (50%):**
    - Focuses on recording financial transactions and assessing the financial position of a company.
    - Essential for decision-making for internal and external stakeholders
2. **Cost Accounting (20%):**
    - Explores specific decisions made by management based on cost-related information.
    - Examples include overhead allocation and pricing decisions.
    - Primarily for internal decision making
3. **Corporate Finance (30%):**
    - Examines the sourcing of funds, evaluation of investment options, and consideration of the time value of money.
    - Aims to make informed decisions regarding investments and financing.

In the upcoming sessions, we will delve into financial accounting, starting with numerical exercises to facilitate learning. Subsequently, we will gradually transition to discussing cost accounting and finance topics.