Foundations of Accounting & Finance

Prof. Arun Kumar Gopalaswamy

Department of Management Studies - IIT Madras

Week - 10

Lecture – 41

Foundations of Corporate Finance - Part I

What is Business / Corporate Finance?

Corporate Finance addresses the following three questions:

1) ***What long-term investments should the firm choose?***

To finance any long-term investments, a firm must carefully select from the available options. For instance, if the firm decides to establish a manufacturing facility for a particular product, it constitutes long-term investment. The capital required to set up the entire manufacturing facility, including the cost of purchasing plant and machinery, spare parts, and constructing the building, represents a long-term commitment, as the firm anticipates deriving benefits from it over an extended period. Therefore, identifying suitable sources for funding such venture becomes crucial.

There are various types of long-term investments to consider. The firm may opt to establish a manufacturing plant domestically or invest in a facility overseas. Moreover, the location of the plant, such as Tamil Nadu, Karnataka, or the Northeast, may offer specific advantages such as tax benefits. Alternatively, the firm might explore international opportunities in countries such as Maldives or Mauritius or one of the tax heavens. Additionally, the choice of product and its relevance to the company's operations plays a significant role in this decision-making process.

Ultimately, the firm needs to evaluate how each potential investment aligns with its long-term goals and strategic objectives. Selecting the most appropriate long-term investment is a critical aspect of financial planning and requires careful consideration of various factors.

2) ***How should the firm raise funds for the selected investments?***

After determining the most feasible project, three options emerge. Firstly, the firm can choose to invest in a manufacturing plant in Tamil Nadu, India. Alternatively, it may decide to invest partially in manufacturing and acquire the remaining externally. The third option involves setting up the manufacturing plant in a different state, such as a north eastern state, despite increased cost of logistics. Now, amidst these choices, the firm must identify the optimal choice based on factors like anticipated returns and associated risks.

The decision-making process hinges based on several considerations, including the time value of money and expected returns. However, the crucial question remains: how should the firm finance these investments? Should it seek funding through equity or debt? In terms of equity, should the firm opt for an initial public offering (IPO) or pursue a private placement? As for debt, should it consider raising public debt in India or explore foreign currency debt options?

The complexity of the decision is evident. Not only must the firm select the most promising project for investment, maximizing returns while mitigating risks, but it must also devise a suitable strategy for raising the necessary funds.

Example

For example, let us consider an infrastructure project, like a 30-year road project. The initial investment might amount to 30,000 crores. Given the lengthy period required to recoup the investment—typically 20 to 30 years—short-term debt instruments, such as five-year debentures, are unsuitable. Instead, issuing long-term bonds, with durations of 10, 20, or even 30 years, aligns with the project's timeline. By servicing the bonds with revenue generated from the road project, the firm ensures a matching of assets and liabilities, thus managing its ALM (asset liabilities management) issues effectively.

Risk aspect in addition to the time aspect

There is also a risk aspect to consider. For instance, if I intend to invest in the stock market, potential investors may hesitate due to the high uncertainty and risk involved. Consequently, they may demand a higher expected return to compensate for this risk. Therefore, when raising funds, it is essential to not only consider the time horizon of the investment but also factor in the associated risks.

In this scenario, the goal is to raise funds in a manner that addresses both the time required for the investment and the risk involved. Ultimately, the aim is to secure funds at the lowest possible cost. As the risk of the investment increases, so does the cost of funds. Therefore, selecting a relatively less risky investment can help lower the cost of funds.

However, it is not always necessary to choose the least risky project to minimize the cost of raising funds. Some projects inherently carry higher risks, leading to higher cost of funds. Therefore, the decision-making process involves evaluating the available options to select the best investment and determine the most effective method to raise funds while considering both risk and return.

3) How should short-term assets be managed and financed?

This aspect is commonly referred to as working capital management. But what does working capital management entail? Let us illustrate with a simple example.

Suppose I sell goods on a 30-day credit. In theory, customers should pay me within 30 days. However, if I am inefficient in collecting payments and my average collection period extends to 45 days, it creates a discrepancy. Meanwhile, when I procure raw materials, suppliers typically grant me only a 20-day credit period. This misalignment necessitates borrowing to meet payment obligations, creating a cycle of increased borrowing due to delayed collections.

This inefficiency in cash conversion increases the need for borrowing continuously. That is one aspect of managing short-term assets. Another aspect involves ensuring that cash is not idle. For instance, if purchases occur only once a month but sales happen continuously throughout the month, cash accumulates daily. Leaving this cash idle is not optimal as idle money does not generate returns. If a company consistently leaves cash idle, it fails to meet investor expectations. Therefore, engaging in treasury operations becomes necessary to optimize cash utilization.

Treasury operations

What is a treasury operation? It involves actively managing excess cash by investing in such a way that it can be liquidated when needed. For instance, if funds are required on the first of the next month to pay for purchases, these securities should be readily convertible to cash to cover expenses on that day. Additionally, any surplus cash should be strategically invested to generate returns.

Summary of corporate finance

In essence, corporate finance or business finance revolves around three core aspects. Firstly, it involves selecting the best investment option among available choices. This decision is influenced by factors such as risk appetite, expected returns, and long-term cost of funds. Secondly, once the investment option is chosen, the focus shifts to selecting the most suitable source of funds to finance it. This decision also impacts the overall investment strategy. Lastly, attention is directed towards short-term money management, including working capital and day-to-day operations. These three fundamental aspects encompass the essence of corporate finance, guiding decision-making processes within businesses.

Balance sheet model of the firm

When discussing the balance sheet, we delve into the value of the assets, which encompasses current assets, fixed assets, and more. As an investor, my primary concern is in understanding the total firm value and value of equity. This value of equity is derived from the total value of assets minus liabilities and debt.

Valuation is predominantly influenced by what is presented on the left-hand side of the balance sheet. The balance sheet model of a firm is depicted below:

Total Value of Assets: Total Firm Value to Investors:

Current Assets

Fixed Assets
1 Tangible
2 Intangible

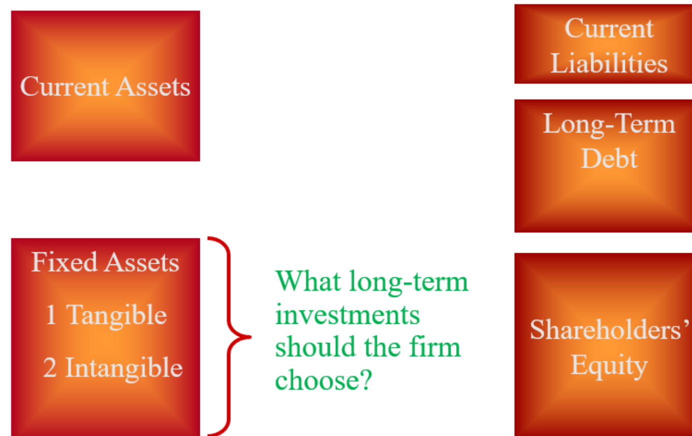
Current Liabilities

Long-Term Debt

Shareholders' Equity

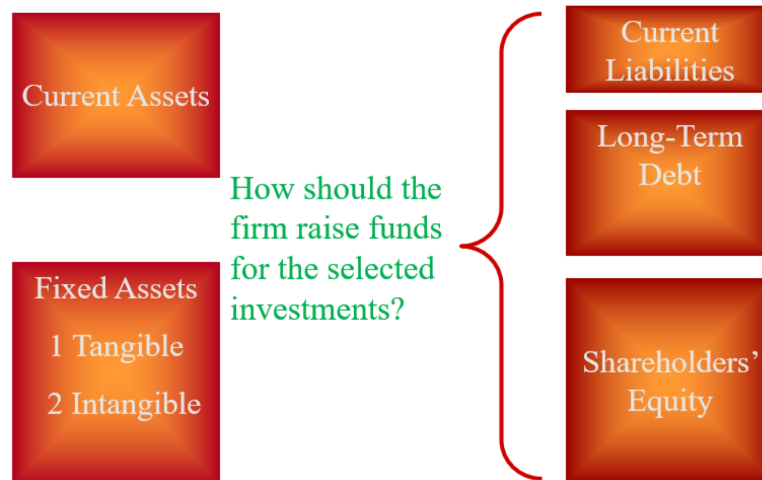
The Capital Budgeting Decision

Moving on to the capital budgeting decision, we focus on determining the best long-term investments for the firm as depicted in the figure below. This decision is closely tied to the firm's equity and long-term debt, as they represent the primary sources of funds for such investments.



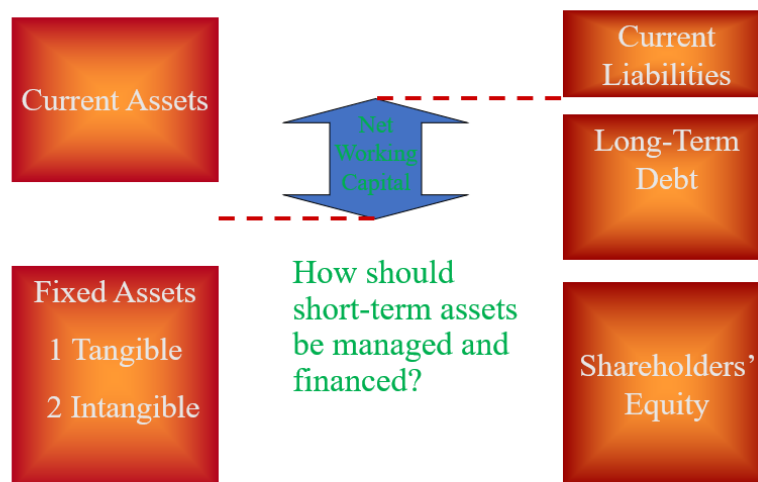
The Capital Structure Decision

Next, we address the capital structure decision, which involves determining how the firm should raise funds for selected investments as highlighted in the following figure. This decision impacts the overall financial health of the firm and is crucial in optimizing the capital structure.



Short-Term Asset (Working Capital) Management

Finally, we touch upon short-term asset management, or working capital management. As depicted in the figure below, this entails managing current assets and liabilities to ensure the firm can meet its short-term obligations effectively.

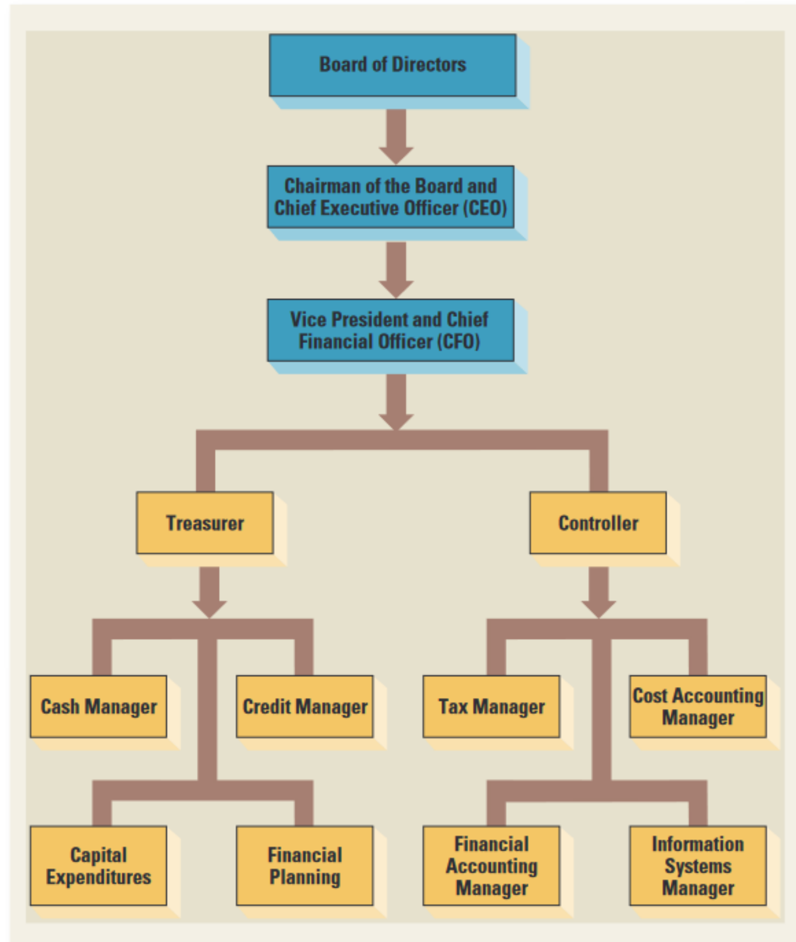


Summary of financial decisions

In essence, the firm's financial decisions revolve around three key aspects. Firstly, determining how to raise funds, primarily through debt and equity, while also considering current liabilities. Secondly, deciding on long-term investments, focusing on fixed assets. Thirdly, managing the allocation of capital, which involves maintaining a balance between current assets and liabilities to support business expansion and operations.

The Financial Manager

In most organizations, the finance department typically follows a structure similar to the one depicted below:



However, the specific designations may vary from one organization to another.The finance department is typically led by the CFO or chief financial officer, who is responsible for overseeing all financial activities within the organization. The CFO reports to the CEO, MD, or chairman of the board, and often interacts with the board of directors as well.

Below the CFO, the department functions with two main objectives in mind**.**

1) ***Treasury function***

The treasury function, encompasses various responsibilities. The treasury function primarily focuses on cash management, which involves determining where to invest short-term funds and how to secure short-term borrowing when needed. This includes decisions on where to park excess cash and identifying the best avenues for short-term borrowing. Additionally, the treasurer

oversees credit management, which involves managing the terms of credit extended to customers and negotiating favourable terms with suppliers to optimize cash flow.

Furthermore, the treasury function is responsible for capital expenditure (capex) management, which involves assessing and planning for additional investments, such as purchasing new machinery or making other capital expenditures. This entails evaluating the organization's capital needs and coordinating the allocation of funds accordingly. Additionally, the treasury function is crucial in overall financial planning, ensuring the organization's financial stability and sustainability over the long term.

2) *Controller function*

The controller function, often referred to as the accounting manager, encompasses several key responsibilities within the finance department. This role typically includes overseeing cost accounting aspects, which involves managing product and unit costs to ensure accurate cost analysis and pricing decisions.

Additionally, the controller oversees financial accounting, which involves recording and tracking all financial transactions within the organization. This includes maintaining detailed records of revenues, expenses, assets, and liabilities to ensure accurate financial reporting.

The controller also works closely with IT personnel to integrate financial systems and ensure data accuracy and integrity. Further, the controller is responsible for internal audit functions, which involve conducting audits of financial processes and controls to ensure compliance with regulations and internal policies. In some cases, the controller may also oversee tax compliance, ensuring that the organization meets all government tax requirements and regulations.

Overall, the controller function plays a vital role in maintaining financial integrity and ensuring compliance within the organization. This function interacts closely with the CFO, CEO, and other key stakeholders to provide accurate financial information.