Foundations of Accounting & Finance

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Week - 10

Lecture – 42

Foundations of Corporate Finance - Part II

Forms of Business Organization

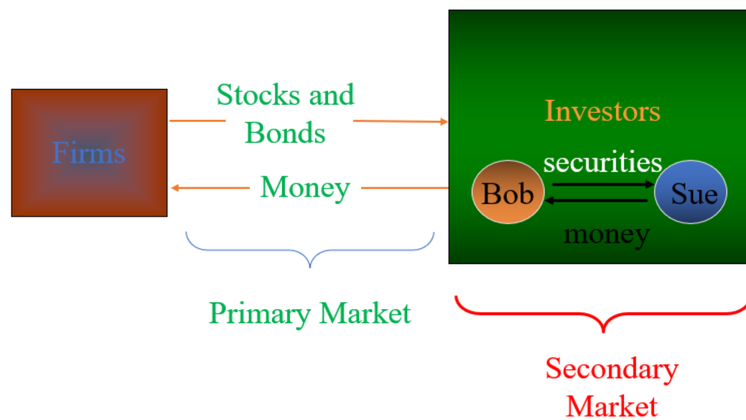
1. Sole Proprietorship:
    - A business owned and operated by a single individual.
    - The proprietor has complete control over the business and is personally liable for all debts and obligations.
2. Partnership:
    - A business structure where two or more individuals share ownership and management responsibilities.
    - Partnerships can be further categorized into:
        - General Partnership: Partners share equally in the profits and losses, and each partner is personally liable for the debts and obligations of the business.
        - Limited Partnership: Consists of one or more general partners who manage the business and are personally liable, and one or more limited partners who invest capital but have limited liability.
3. Corporation:
    - A separate legal entity owned by shareholders.
    - Corporations have limited liability, meaning that the shareholders' personal assets are protected from the debts and liabilities of the corporation.
    - Corporations can be further classified as:
        - Public Company: A corporation whose shares are publicly traded on a stock exchange and available to the general public.

- Private Company: A corporation whose shares are not publicly traded and are owned by a select group of individuals or entities.

In the context of financial management, the focus is primarily on corporations, particularly public companies. These entities play a significant role in financial markets and interact extensively with investors and stakeholders.

Financial Markets

Financial markets play a pivotal role in facilitating the exchange of capital between firms seeking funds and investors looking to invest their capital. The interaction between these two entities occurs through various channels within the financial markets as depicted below:



1. Primary Market:

   - Firms raise capital by issuing securities such as equity shares or debt instruments.
   - This initial issuance of securities is conducted in the primary market through methods like Initial Public Offerings (IPOs).
   - Regulatory bodies like the Securities and Exchange Board of India (SEBI) oversee these primary market activities to ensure transparency and compliance.

2. Secondary Market:

   - Once securities are issued in the primary market, they are listed on exchanges such as the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE).
   - Investors can then buy and sell these securities among themselves in the secondary market.
   - The secondary market provides liquidity to investors, allowing them to enter and exit their investments easily.

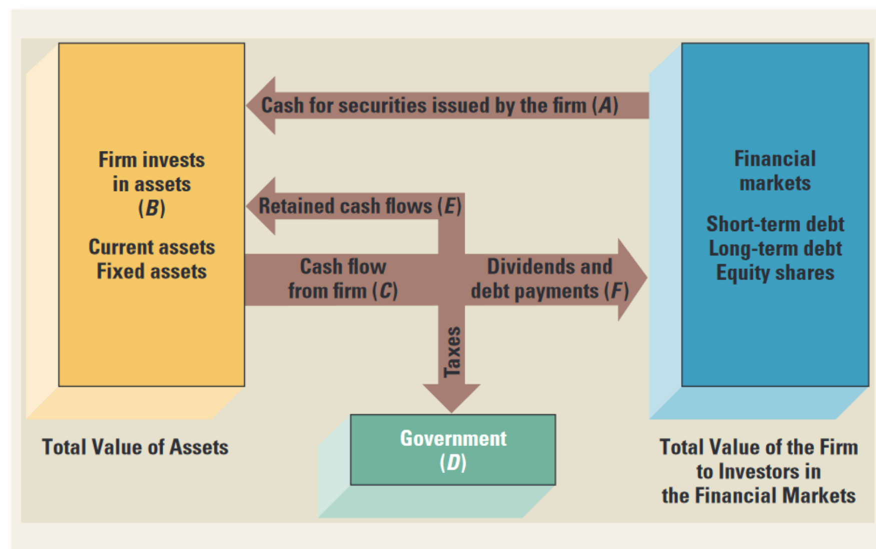
Interaction in the Financial Markets:

- Firms issue securities (equity and debt instruments) to raise capital.
- Investors, including individuals, institutional investors, and private investors, purchase these securities.
- The funds raised by firms are utilized for various purposes such as business expansion, capital expenditure, or debt repayment.
- Investors can trade their securities with other investors in the secondary market, allowing for liquidity and price discovery.
- The process of buying and selling securities in the secondary market involves transactions between investors, facilitated by exchanges like NSE and BSE.

Overall, financial markets serve as a crucial link between firms and investors, enabling efficient allocation of capital and fostering economic growth.

Cash Flows between firms & Financial Market

Cash flows between firms and the financial market is simplified in the following figure and explained later:



1. Investors invest money in the firm through the financial markets, primarily in the form of equity or debt securities issued by the firm.
2. The firm receives cash from investors, which it utilizes to invest in various assets, including fixed assets and current assets, to operate the business.

3. As the firm operates, it generates cash flows from its activities, resulting from the utilization of the invested capital.
4. These cash flows may be used to fulfil obligations such as paying interest on debt (if applicable) or distributing dividends to shareholders.
5. If dividends are not fully distributed, or if the firm decides not to pay dividends, the remaining cash is retained by the firm as retained earnings, contributing to its equity capital.
6. Government taxation may also apply to the firm's profits, leading to mandatory tax payments, regardless of dividend distributions.
7. The interaction between firms and the financial market involves the movement of money from investors to the firm, investment in assets, generation of cash flows, and distribution or retention of cash flows, influenced by factors such as dividend policies and tax obligations.

The Goal of Financial Management

What is the correct goal?

- Maximize profit?
- Minimize costs?
- Maximize market share?
- Maximize shareholder wealth?

Most importantly, to maximize shareholder wealth. How does one achieve this? By generating substantial cash flows and ensuring that the equity's market price reflects its true value, driven by performance rather than speculation. In essence, the primary objective of financial management or a financial manager is to maximize shareholder wealth by delivering consistent and sustainable value.

The correct goal, encompassing all others, is indeed maximizing shareholder wealth. While all four goals mentioned—maximizing profit, minimizing costs, maximizing market share, and maximizing shareholder wealth—are important, the ultimate objective is to enhance shareholder wealth. This goal inherently encompasses the others, as achieving a large market share, generating profits, and minimizing costs are all means to ultimately increase shareholder value. Therefore, maximizing shareholder wealth serves as the overarching objective that aligns with and integrates the other three goals.

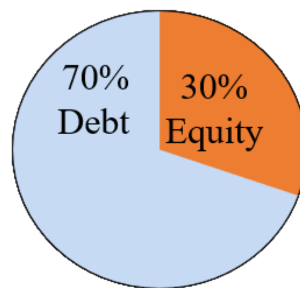
Capital Structure

The concept of capital structure in finance refers to how a company finances its operations and growth through a combination of debt and equity. Long-term debt can take various forms such as bonds, debentures, loans from banks or financial institutions, or foreign currency loans. Equity can be raised through private placements, investments from high net-worth individuals (HNIs), or through an initial public offering (IPO).

The primary objective when determining the capital structure is to raise funds in the most efficient and cost-effective manner possible. This involves finding the optimal combination of debt and equity that minimizes the cost of capital for the firm. By minimizing the cost of capital, the firm can maximize its shareholder value, as demonstrated in the previous section where we emphasized the importance of minimizing costs to enhance shareholder wealth. Therefore, achieving an optimal capital structure is crucial for enhancing the firm's overall value and ensuring sustainable growth.

Objective of every financial manager

The objective of every financial manager is to increase the value of the firm represented by the pie in the diagram.



This entails making decisions regarding the capital structure, which determines the proportion of debt and equity used to finance the firm's operations. By optimizing the capital structure to minimize costs and enhance efficiency, the financial manager aims to maximize the value of the firm.

Determining the best possible capital structure involves analysing various factors such as the firm's risk tolerance, cost of capital, market conditions, and financial goals. This decision-making process is a key aspect of financial management and will be explored further in the second part of this course.

Introduction to the concept of time value of money

The concept of the time value of money is fundamental in finance and has significant implications for investment decisions. Essentially, it recognizes that the purchasing power of money changes over time due to factors such as inflation and opportunity cost.

Consider a simple example: If you invest 1000 rupees today and receive the same amount back in five years, you may not be happy. Because the value of that 1000 rupees in the future will be less than its value today due to inflation. In other words, the goods or services you can purchase with that amount of money will likely cost more in the future.

In financial terms, this means that receiving a certain amount of money in the future is less valuable than receiving the same amount today. For instance, if you invest $10,000 in a project and expect to receive $3,000 in the first year, $4,000 in the second year, and $3,000 in the third year, totalling $10,000, may not be a wise investment. This is because the value of the future cash flows is lower when discounted back to present value, considering the time value of money.

In essence, the time value of money suggests that a dollar received today is worth more than a dollar received in the future. This concept forms the basis of many financial calculations and investment decisions, which we will explore further in the next session.