Secretarial Practice Class 12

Chapter 1
Introduction to Corporate Finance

Introduction:

- Finance refers to Money and Money Management.
- It includes inflow and outflow of money.
- Success of any business organization depends upon the efficient generation of funds and its use.

Corporate Finance

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

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

Corporate Finance also includes financial planning, study of capital market, money market and share market. Financial organizations and banks also play important role in corporate financing.

The finance manager insures that:

a) The firm has adequate finance
b) They are using right source of funds that have minimum cost
c) The firm utilises raised funds effectively
d) They are generating maximum returns for its owners

Two important decisions for corporate finance:

1) Financing Decision: Capital market is one of the sources of raising the finance. The firm can choose equity capital or debt capital. The firm can also raise the finance by taking loan, public deposits, debentures etc. So, the finance manager ensures that the firm is well capitalised i.e. they have enough capital with right combination of equity and debt.

2) Investment Decision: After raising capital, the finance manager takes the decision of use of funds in systematic manner so that investors get good returns on the same. The firm should know the cost of capital.

Importance of Corporate Finance

Helps in Decision making

Every decision of business should be taken in such a way that it should not hamper the profitability. So management needs to select the best alternatives among the number of available alternatives to increase the profitability.

Helps in Research & Development

Research and development is necessary for the growth and expansion of business. It is very lengthy process so funds needs to be made available through out the research work. It requires continuous finance.

Raising capital for project

Every business firm needs capital to raise its business. The firm can raise funds by issuing shares, debentures, bonds or by taking loans from the banks.

Smooth running of business firm

Smooth flow of finance is needed to pay the salaries of the employees on time, to clear the loans, to purchase raw material, sales promotion and to launch the new products.

Coordination between various activities

Corporate Finance plays vital role in the control and coordination of all the activities in the organization. For eg, if the finance department does not provide the finance to purchase raw material, the production will suffer and consequently it will also affect the sales.

Promotes expansion and diversification

Expansion and diversification needs modern machines and techniques. Corporate finance provides money for the same. So, finance is very important factor in this regard.

Managing risk

The company needs to manage number of risks such as sudden fall in sales, loss due to natural calamity, strikes etc. So, company requires finance to manage such risks.

Replace old assets

Assets such as plant & machinery become old and obsolete over a period of time. So, they need to be replaced by new assets. For that finance is needed to purchase them.

Payment of taxes/ fees

Company has to pay taxes to Government such as income tax, GST (Goods and Service Tax) and fees to Registrar of Companies on different occasions. To pay such taxes, finance is needed.

Payment of capital & dividend

Finance is required to pay dividend to shareholders, interest to creditors, banks etc.

Capital requirements

A. Fixed Capital: It is used for buying fixed assets we are used for longer period of time. These assets are not for resale. It means fixed capital remains in the business for a long time or it is permanent. For eg, capital used for buying land & building, furniture, plant & machinery etc. This is the capital which is needed at the time of establishment of the business. It is also required by existing companies for expansion and development.

- Factors affecting fixed capital requirement:

1) Nature of business
2) Size of business
3) Scope of business
4) Extent of lease or rent
5) Arrangement of sub-contract
6) Acquisition of old assets
7) Acquisition of assets on concessional rate
8) International conditions
9) Trend in economy
10) Population trend
11) Consumer preference
12) Competitive factor

B) Working Capital: Capital which is used to carry out day to day business activities is Working Capital. Once the fixed capital requirement is estimated, it is necessary for the firm to estimate the working capital amount which would be needed to ensure smooth functioning of the business. The business firm needs funds for the storage of adequate raw material,to maintain sufficient stock of finished goods, to pay overheads such as accounting fees, advertising, insurance, interest, legal fees, rent repairs, taxes, telephone bills, travel expenses etc. For all these factors a firm should have adequate working capital.

- Factors affecting working capital requirement:

1) Nature of business
2) Size of business
3) Volume of sales
4) Production cycle
5) Business cycle
6) Terms of purchase & sales
7) Credit control
8) Growth & Expansion
9) Management ability
10) External factors

Capital Structure

A company can raise the capital in two forms i.e. a) owned capital and b) borrowed capital. Owned capital consists of equity share capital, preference share capital, reserves and surplus. Borrowed capital means capital in the form of borrowed resources such as debentures, loans etc. So, capital structure means ‘security mix’.

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 its assets.”

Components of Capital Structure

A. **Equity Share Capital**: It is a basic source of capital. In the equity share capital, the shareholders get the dividend and the repayment of the capital after it is paid to the preference shareholders. They are the ultimate risk owners. They get the fluctuating rate of dividend depending upon the profits.

B. **Preference share Capital**: These shareholders have the first priority over the equity shareholders to get the dividend and the repayment of the capital. These shareholders get fixed rate of dividend irrespective of the profit.

C. **Retained earnings**: It represents the part of the profit a company has left over after paying all the taxes and the dividend to the shareholders. It is the internal source. In simple words, it is nothing but the ploughing back of the profit.

D. **Borrowed Capital**: It contains the following:

1. ***Debenture***: It is a type of loan issued by the company to raise the funds from the public. The company needs to pay interest on the debentures at the agreed rate.

2. ***Term Loan***: The term loans include short-term-loans and long-term-loans which are provided by banks and other financial institutions. They have fixed rate of interest.

Below is the balance Sheet of the company to understand the concept.

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

Liabilities	Amount	Assets	Amount
Share Capital		**Fixed Assets**	
₹10000 equity shares of 10 each fully paid	1,00,000	Building	4,00,000
		Plant & Machinery	2,00,000
		Current Assets	
5,000 preference shares of ₹100 each fully paid	5,00,000	Sundry Debtors	1,00,000
		Inventories	50,000
Reserves and Surplus	50,000	Cash in hand	10,000
		Cash at bank	40,000
Liabilities			
1000, 10% debentures of ₹100 each fully paid	1,00,000		
Sundry creditors	30,000		
Bills Payable	20,000		
	8,00,000		**8,00,000**

The calculation of the Capital Structure is as follows:

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

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

= 7,50,000

Thank You

LUCAS & FRIENDS