Role of the finance decision in corporate finance

Economics

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Corporate finance is the portion of finance and accounting that deals with the tools and data surrounding financial decisions for a company. In particular, there are specific portions of corporate finance that are necessary to determine the best course of action in a given financial decision. These portions are all intertwined in that they are utilized to make a given financial decision and one cannot be considered without the others. Investment by managers in projects seek to maximize the value of the firm, such projects require specific financing that fits the company goals and situation, and lastly the shareholder value must be maximized if no projects require the necessary capital and a dividend is to be paid to shareholders (Damodaran, 2005). Relating to firm value maximization, it is the ultimate goal of corporate finance, which is assumed to be maximizing the value generated by a firm’s investment, financing, and dividend decisions (Damodaran, 2007). This can be seen as the objective drive of corporate finance; however, managers outside of finance would likely agree that their goal is to maximize the value of the organization, as the interests of the organization and those of the manager are likely convergent.

To make the investment decision, managers need to allocate resources between several projects and/or business units through capital budgeting. The value of a given project must be estimated given its cost, development time, and business impact. This process, also called capital budgeting or investment appraisal, can be complex, given the number of valid methods for determining the value of a firm’s project. For instance, net present value, internal rate of return, and the simplified payback method all attempt to determine the same value of a project; however, they may result in

drastically different answers, especially when a single method is taken in the absence of the others (Berman, Knight, Case, 2008). Thus, it may be advisable to utilize the different methods, along with a simple sensitivity analysis, to help determine an investment decision.

The finance decision of corporate finance is important, because this is the decision that controls the type (and amount) of debt the firm acquires. Generally, the more debt a firm has, the more difficulty it will encounter in conducting its operations. This decision, also called capital structure, is important because there are different advantages to the types of capital that are available to a firm. Long-term debt and short-term debt are both types of capital in which a fixed amount is owed to another party with which an interest rate is, usually, attached. However, for equity, capital is obtained through the issuing of additional shares, or other types of ownership, to investors. As mentioned before, the less debt the better a firm is likely to perform; this is certainly the case when considering the debt to equity ratio. Simply put, the more debt (or liabilities) a firm has can result in some negative consequences. For instance, earnings can be impacted due to interest rate adjustments and due to ratio similarities within industries, divergent results could have negative consequences for ratings and/or stock prices (“ Debt/equity ratio definition,”).

The remaining portion of capital finance is the dividend decision. It is important to remember that the owners/shareholders of a firm are entitled to the remaining cash a company generates for a given period after investment projects and financing decisions have been resolved. Because this is due to a requirement to increase the value of shares held by investors, two forms of

dividends can be issues: cash dividends or a stock buyback. The cash dividend is simply a portion of earnings given to the owner of each outstanding share. Conversely, the stock buyback involves the company purchasing shares on the common market to increase the value of the remaining shares. Both methods increase value for shareholders; however, they can have significant impact on different metrics (such as the debt to equity ratio) and must be considered carefully by managers.

Pursuing a low cost strategy can impart a number of benefits to an organization; however, relating to corporate finance, the most visible impact is within financing decisions. The ability to utilize internally available cash to avoid issuing new equity or acquiring new debt is very useful. This is particularly the case in economic environments, similar to those currently being experienced, in which debt and corporate lending has considerably slowed.

Given that corporate finance is chiefly concerned with investment, finance, and dividend decisions, the precepts of firm value maximization and a low-cost strategy both impart a lasting influence on effective finance managers. Given the current economic climate, it would be prudent to pursue a policy of reducing costs in a reasonable manner that does not impact sales and/or customer satisfaction. Furthermore, this would help maximize the firm’s value in that it would reduce the costs and liabilities associated with ongoing operation.