Financial Management

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Preface

This book, in a sense, is an outgrowth of the teaching experience of the authors. In our academic interaction with teachers, postgraduate students and practising financial executives, we have found that they face considerable difficulty in using the available foreign books in this growing academic discipline. The present volume, in a way, represents a modest attempt to provide a solution to their problems.

It is intended primarily for postgraduate students in commerce and chartered and cost accountancy. Those doing similar courses in business management or appearing in the restructured civil services and other competitive examinations will hopefully find it equally useful. Its usefulness, however, is not confined to academicians alone. It may also be of special interest to the practitioners in the field.

In keeping with the aims of the book, we have attempted to present the text in a lucid and simple style; the treatment is comprehensive and by and large non-mathematical. Another notable feature of this volume is that the discussions of the concepts and theories are invariably followed by exhaustive illustrative problems. To test the understanding of the readers as also to enable them to have sufficient practice, quite a large number of exercises have also been given at the end of the chapters. A select bibliography at the end of the book would be of special interest to the teachers of the subject.

The theme of Financial Management is structured round the decision-making in the three inter-related financial areas: investment—long-term as well as current assets; financing; and dividend policy. Also included are the important tools of financial planning and management. The main discussion is divided into six parts comprising twenty chapters.

Part I of the book, which provides the setting to the detailed discussions that follow subsequently, contains two chapters. Chapter 1 outlines the *nature* of financial management in terms of its emerging and contempo-

rary scope and objectives. The concern of Chapter 2 is with the time value of money, i.e. compounding and discounting or present value techniques and their practical applications in financial decision-making, particularly capital budgeting.

Part II, comprising two chapters, is devoted to the tools of analysis in financial management. While Chapter 3 explains and illustrates the statement of changes in financial position (funds flow and cash flow), the financial statement analysis (ratio analysis) is described in Chapter 4.

The subsequent discussions relate to the important decission-making areas in financial management. Thus, Part III focusses on the first and the most important aspect, namely, the long-term investment decision or capital budgeting. It consists of five chapters. The first of these (Chapter 5) presents the general principles of capital budgeting with particular reference to the type of information required (cash flow) and its essential ingredients. This is followed in Chapter 6 by a detailed account of the capital budgeting evaluation techniques, traditional as well as time-adjusted or discounted cash flow. The incorporation of risk and uncertainty into the capital budgeting exercise is elaborated in Chapter 7. Chapter 8 attempts to develop the concept and measurement of cost of capital—the most controversial element in financial management. The last chapter of this part (Chapter 9) dwells on the Indian corporate practices pertaining to capital expenditure decision-making in both the public and private sectors.

The second important decision involved in financial management (financing decision) is covered in the three chapters of Part IV. The discussions in Chapter 10 pertaining to the two inter-related aspects, i.e. operating and financial leverage, set the framework for the capital structure decision of a firm. The capital structure theories, reflecting the controversy in the financial literature regarding the theoretical relationship between capital structure, cost of capital and value of a firm are examined in Chapter 11. In the light of the conclusions of this chapter, the considerations having a bearing on the designing of an appropriate capital structure are highlighted in the next chapter (Chapter 12).

Part V of the volume is devoted to the relevant dimensions of dividend policy decision. The first aspect, viz. the controversy in the academic literature as regards the relevance of dividend policy to the value of the enterprise, is the subject matter of Chapter 13. It is against the background of this theoretical discussion that Chapter 14 dwells on the determinants of an appropriate dividend policy.

Finally, Part VI of the book focusses on the management of current assets, more popularly designated as working capital management. The first three chapters of this part between them provide an overview of working capital management and deal respectively with the theory of working capital management in terms of the basic strategies for efficient management of current assets and current liabilities (Chapter 15), the planning and determinants of working capital (Chapter 16) and the financing and

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control of working capital in India with particular reference to the report of the Tandon Committee (Chapter 17). The next three chapters look into the management of the individual components of current assets. While cash management is the theme of Chapter 18, the various dimensions of receivables management are explained in Chapter 19. The last chapter (Chapter 20) discusses the relevant aspects of inventory management.

Detailed solutions of all the exercises included in each chapter of this book are provided in our book: **Management Accounting and Financial Management—Problems and Solutions.**

In the preparation of this book we have received encouragement and support from various quarters. In particular we would like to thank Mr. H.C. Jain, Librarian of the University South Campus Library for the excellent library support he provided to us at short notice. Mr. Subhash Chander deserves our thanks for speedy and accurate typing of the final draft.

Finally, we would be failing in our duty if we do not acknowledge the deep debt of gratitude that we owe to the various authors whose writings have provided an insight into the intricacies of the subject.

M Y KHAN
P K JAIN

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Part I
BACKGROUND

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1

Nature of Financial Management
Scope and Objectives

The term 'nature' as applied to financial management refers to its functions, scope and objectives. Financial management, as an academic discipline, has undergone fundamental changes as regards its scope and coverage. In the early years of its evolution it was treated synonymously with the raising of funds. In the current literature pertaining to this growing academic discipline, a broader scope so as to include, in addition to procurement of funds, efficient use of resources is universally recognised. Similarly, the academic thinking as regards the objective of financial management is also characterised by a change over the years. The object of this chapter is to describe the evolving functions and objectives of financial management in the academic literature to serve as a background to a detailed account of its various facets in the discussions that follow subsequently. We first outline the scope and functions of financial management. This is followed by an elaboration of the objectives of financial management.

SCOPE OF FINANCIAL MANAGEMENT

The approach to the scope and functions of financial management is divided, for purposes of exposition, into two broad categories : (*a*) Traditional Approach, and (*b*) Modern Approach.

Traditional Approach

The traditional approach to the scope of financial management refers to its subject matter in the academic literature in the initial stages of its evolution as a separate branch of academic study. The term "corporation finance" was used to describe what is now known in the academic

world as "financial management". As the name suggests, the concern of corporation finance was with the financing of corporate enterprises. In other words, the scope of finance function was treated by the traditional approach in the *narrow* sense of *procurement* of funds by corporate enterprises to meet their financing needs. The term "procurement" was used in a broad sense so as to include the whole gamut of raising funds externally. Thus defined, the field of study dealing with finance was treated as encompassing three inter-related aspects of raising and administering resources from outside: (*i*) the institutional arrangement in the form of financial institutions which comprise the organisation of the capital market; (*ii*) financial instruments through which funds are raised from the capital markets and the related aspects of practices and the procedural aspects of capital markets; and (*iii*) the legal and accounting relationships between a firm and its sources of funds. The coverage of corporation finance was, therefore, conceived to describe the rapidly evolving complex of capital market institutions, instruments and practices. A related aspect was that firms require funds at certain episodic events such as merger, liquidation, re-organisation and so on. A detailed description of these major events constituted the second element of the scope of this field of academic study. That these were the broad features of the subject matter of corporation finance is eloquently reflected in the academic writings around the period during which the traditional approach dominated the academic thinking.[1] Thus, the issues to which the literature on finance addressed itself was how resources could best be raised from the combination of the available sources.

The traditional approach to the scope of the finance function evolved during the 1920s and 1930s dominated the academic thinking during the forties and through the early fifties. It has now been discarded as it suffers from serious limitations. The weaknesses of the traditional approach fall into two broad categories : (*i*) those relating to the treatment of various topics and the emphasis attached to them; (*ii*) those relating to the basic conceptual and analytical framework of the definitions and scope of the finance function.

As regards the first type of criticism of the traditional approach, the emphasis of the academic literature on issues relating to the procurement of funds by corporate enterprises was challenged during the period

[1] To name a few : Greene, T. L., *Corporation Finance*,(New York), Pitman, 1897; Meade, E. S., *Corporation Finance*,(New York), Appleton, 1910; Dewing, A. S., *Corporate Promotions and Re-organisations*,(Cambridge, Mass.), Harvard University Press, 1914; Dewing, A. S., *The Financial Policy of Corporations*, (New York), Ronald, 1919.

the approach dominated the scene itself[2]. The traditional treatment of finance was criticised for the following reasons[3] :

Since the finance function was equated with the issues involved in raising and administering funds, the theme was woven around the viewpoint of the suppliers of funds such as investors, investment bankers and so on, i.e. the outsiders. It implies that no consideration was given to the viewpoint of those who had to take internal financial decisions. The traditional treatment was, in other words, the *outsider-looking-in approach*. The limitation was that internal decision-making (i.e. *insider-looking-out*) was completely ignored.

The second ground of criticism of the traditional treatment was that the focus was on financing problems of corporate enterprises. To that extent the scope of financial management was confined only to a segment of the industrial enterprises, as non-corporate organisations lay outside its scope.

Yet another basis on which the traditional approach was challenged was that the treatment was built too closely around episodic events, such as promotion, incorporation, merger, consolidation, reorganisation and so on. Financial management was confined to a description of these infrequent happenings in the life of an enterprise. As a logical corollary, the day-to-day financial problems of a normal company did not receive any attention.

Finally, the traditional treatment was found to have a lacuna to the extent the focus was on long-term financing. Its natural implication was that the issues involved in working capital management were not in the purview of finance function.

The limitation of the traditional approach was, however, not entirely based on treatment or emphasis of different aspects. In other words, its weaknesses were more fundamental. The conceptual and analytical shortcoming of this approach arose from the fact that to the extent it confined financial management to issues involved in procurement of external funds, it did not consider the important dimension of allocation of capital. The conceptual framework of the traditional treatment ignored what Solomon aptly describes as the *central issues of financial management*[4]. These are : Should an enterprise commit capital funds to certain purposes ? Do the expected returns meet financial standards of performance ? How should these standards be set and what is the cost of capital funds to the enterprise ? How does the cost vary with the mixture of financing methods used ? In the absence of the coverage of these crucial

[2] For instance, Lincoln, E. E., *Problems in Business Finance*, (Chicago), Shaw, 1921; Gerstenberg, C. W., *Corporation Finance*, (Englewood Cliffs), Prentice-Hall, 1915.

[3] Solomon, E., *Theory of Financial Management*, (New York), Columbia University Press, 1969, p. 5.

[4] *Ibid*.. p. 7.

aspects, the traditional approach implied a very narrow scope for financial management. The modern approach provides a solution to these shortcomings.

Modern Approach

The modern approach views the term financial management in a broad sense and provides a conceptual and analytical framework for financial decision-making. According to it, the finance function covers both acquisition of funds as well as their allocation. Thus, apart from the issues involved in acquiring external funds, the main concern of financial management is the efficient and wise allocation of funds to various uses. Defined in a broad sense, it is viewed as an integral part of over-all management.

The new approach is an analytical way of viewing the financial problems of a firm. The main contents of this approach are[5] : What is the total volume of funds an enterprise should commit ? What specific assets should an enterprise acquire ? How should the funds required be financed ? Alternatively, the principal contents of the modern approach to financial management can be said to be : (*i*) How large should an enterprise be, and how fast should it grow ? (*ii*) In what form should it hold assets ? (*iii*) What should be the composition of its liabilities ?

The three questions posed above cover between them the major financial problems of a firm. In other words, financial management, according to the new approach, is concerned with the solution of three major problems relating to the financial operations of a firm, corresponding to the three questions, namely, investment, financing and dividend decisions. Thus, financial management, in the modern sense of the term, can be broken down into three major decisions as functions of finance. They are : (*i*) The investment decision, (*ii*) The financing decision, and (*iii*) The dividend policy decision. We briefly outline the main components of these in the following discussion.

FUNCTIONS OF FINANCE

Investment Decision

The investment decision relates to the selection of assets in which funds will be invested by a firm. The *assets* which can be acquired fall into two broad groups : (*i*) long-term assets which will yield a return over a period of time in future, (*ii*) short-term or current assets defined as those assets which in the normal course of business are convertible into cash usually within a year. Accordingly, the asset selection decision of a firm is of two types. The first of these involving the first category of

[5] *Ibid.*, p. 8.

assets is popularly known in the financial literature as *capital budgeting*. The aspect of financial decision-making with reference to current assets or short-term assets is popularly designated as *working capital management*.

Capital Budgeting

Capital budgeting—the long-term investment decision—is probably the most crucial financial decision of a firm. It relates to the selection of an asset or investment proposal or course of action whose benefits are likely to be available in future over the life-time of the project. The long-term assets can be either new or old/existing ones. The first aspect of the capital budgeting decision relates to the choice of the new asset out of the alternatives available or the re-allocation of capital when an existing asset fails to justify the funds committed. Whether an asset will be accepted or not will depend upon the relative benefits and returns associated with it. The measurement of the worth of the investment proposals is, therefore, a major element in the capital budgeting exercise. This implies a discussion of the methods of appraising investment proposals.

The second element of the capital budgeting decision is the analysis of risk and uncertainty. Since the benefits from the investment proposals extend into the future, their accrual is uncertain. They have to be estimated under various assumptions of the physical volume of sale and the level of prices. An element of risk in the sense of uncertainty of future benefits is, thus, involved in the exercise. The return from the capital budgeting decision should, therefore, be evaluated in relation to the risk associated with it.

Finally, the evaluation of the worth of a long-term project implies a certain norm or standard against which the benefits are to be judged. The requisite norm is known by different names such as cut-off rate, hurdle rate, required rate, minimum rate of return and so on. This standard is broadly expressed in terms of the cost of capital. The concept and measurement of the cost of capital is, thus, another major aspect of the capital budgeting decision. In brief, the main elements of the capital budgeting decisions are : (*i*) the total assets and their composition, (*ii*) the business risk complexion of the firm, and (*iii*) concept and measurement of the cost of capital.

Working Capital Management

Working capital management is concerned with the management of the current assets. It is an important and integral part of financial management as short-term survival is a pre-requisite to long-term success. One aspect of the working capital management is the trade-off between profitability and risk (liquidity). There is a conflict between profitability and liquidity. If a firm does not have adequate working capital, i.e. it does not invest sufficient funds in current assets, it may become illiquid and

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