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FINANCIAL MANAGEMENT

UNIT – 2

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INVESTMENT DECISIONS

Investment decision It relates to as how the funds of a firm are to be invested into different assets, so that the firm is able to earn highest possible return for the investors. Investment decision can be long-term, also known as capital budgeting where the funds are commited into long-term basis. Short-term investment decision also known as working capital decision and it is concerned with the levels of cash, inventories and debtors . Investment decision can be long-term and short-term.

These assets fall into two categories

Long Term Assets

- **Capital Budgeting**

The decision of investing funds in the long term assets is known as Capital Budgeting. Thus, Capital Budgeting is the process of selecting the asset or an investment proposal that will yield returns over a long period.

The first step involved in Capital Budgeting is to select the asset, whether existing or new on the basis of benefits that will be derived from it in the future.

The next step is to analyze the proposal's uncertainty and risk involved in it. Since the benefits are to be accrued in the future, the uncertainty is high with respect to its returns. Finally, the minimum rate of return is to be set against which the performance of the long-term project can be evaluated.

Short-Term Assets

- **Working Capital Management**

The investment made in the current assets or short term assets is termed as Working Capital Management. The working capital management deals with the management of current assets that are highly liquid in nature.

The investment decision in short-term assets is crucial for an organization as a short term survival is necessary for the long-term success. Through working capital management, a firm tries to maintain a trade-off between the profitability and the liquidity.

In case a firm has an inadequate working capital i.e. less funds invested in the short term assets, then the firm may not be able to pay off its current liabilities and may result in bankruptcy. Or in case the firm has more current assets than required, it can have an adverse effect on the profitability of the firm.

Significance of investment decisions

(a) Investment Linked with Objectives :
An enterprise with an objective of survival and growth, incurs capital expenditure every year and takes investment decisions e.g., investment in fixed assets and inventory.

(b) Long Term Commitments :
A capital project, like hydroelectric project is expected to bring benefits in future years. Such projects require the commitment of funds for future years, and draw the future direction by determining its product, markets, production facilities and technology.

(c) No-Going Back:

It is difficult to reverse a capital project decision.

CAPITAL BUDGETING

Capital budgeting is a company's formal process used for evaluating potential expenditures or investments that are significant in amount. It involves the decision to invest the current funds for addition, disposition, modification or replacement of fixed assets. The large expenditures include the purchase of fixed assets like land and building, new equipments, rebuilding or replacing existing equipments, research and development, etc. The large amounts spent for these types of projects are known as capital expenditures. Capital Budgeting is a tool for maximizing a company's future profits since most companies are able to manage only a limited number of large projects at any one time.

Capital budgeting usually involves calculation of each project's future accounting profit by period, the cash flow by period, the present value of cash flows after considering time value of money, the number of years it takes for a project's cash flow to pay back the initial cash investment, an assessment of risk, and various other factors.

Capital is the total investment of the company and budgeting is the art of building budgets.

FEATURES OF CAPITAL BUDGETING

- **Large Investments**

  Capital Budgeting is related to taking decisions requiring large funds. It is a process used for selecting the high-value capital projects by the management. Managers use capital budgeting for properly analysing different investment opportunities and take decision with proper care.

- **Irreversible Decision**

  The decisions taken through the capital budgeting process are irreversible in nature. This process requires making choices for large fund investment in different capital projects available. A decision once taken becomes difficult to be amended as it involves the allocation of large funds and affects company growth. High-value asset once purchased can't be sold at the same prices and at the same time.

- **High Risk**

  There is a high degree of risk involved in the capital budgeting process. Decisions taken in this process are concerned with future return and the future is uncertain. Future unforeseen like change in fashion and taste, technological and research advancement may lead to higher risk. It, therefore, involves critical analysis before taking any decision as there are a large amount of funds allocated by business through this process.

- **Long Term Effect on Profitability**

Capital Budgeting decisions have long term effects on the profit-earning capacity of the business. It involves decisions regarding large investments providing return to business. Decisions taken through capital budgeting affects both current and future earning potential of the company. Any unwise decision may affect business growth adversely and may be fatal. Therefore capital budget is termed us utmost function for every business which has great influence over its profitability.

- **Impacts Cost Structure**

The decisions taken through the capital budgeting process have a direct impact on the cost structure of the business. Through decision taken in this process, business commits themselves to costs like interest, insurance, rent, supervision etc. If the investment taken does not generate the anticipated income for the business, then it would increase the cost expenses and lead business to losses.

- **Difficult Decisions**

Decisions taken through the capital budgeting process are difficult in nature. Decisions taken here are regarding the future which is uncertain and may have many unforeseen. It, therefore, becomes difficult for managers to choose the most profitable investment providing better return in future.

CAPITAL BUDGETING PROCESS:

A) Project identification and generation:

The first step towards capital budgeting is to generate a proposal for investments. There could be various reasons for taking up investments in a business. It could be addition of a new product line or expanding the existing one. It could be a proposal to either increase the production or reduce the costs of outputs.

B) Project Selection:

There is no such defined method for the selection of a proposal for investments as different businesses have different requirements. That is why, the approval of an investment proposal is done based on the selection criteria and screening process which is defined for every firm keeping in mind the objectives of the investment being undertaken.

Once the proposal has been finalized, the different alternatives for raising or acquiring funds have to be explored by the finance team. This is called preparing the capital budget. The average cost of funds has to be reduced. A detailed procedure for periodical reports and tracking the project for the lifetime needs to be streamlined in the initial phase itself. The final approvals are based on profitability, Economic constituents, viability and market conditions.

C) Project Screening and Evaluation:
This step mainly involves selecting all correct criteria's to judge the desirability of a proposal. This has to match the objective of the firm to maximize its market value.
The tool of time value of money comes handy in this step.
Also the estimation of the benefits and the costs needs to be done. The total cash inflow and outflow along with the uncertainties and risks associated with the proposal has to be analyzed thoroughly and appropriate provisioning has to be done for the same.

D) Implementation:
Money is spent and thus proposal is implemented. The different responsibilities like implementing the proposals, completion of the project within the requisite time period and reduction of cost are allotted. The management then takes up the task of monitoring and containing the implementation of the proposals.

E) Performance review:
The final stage of capital budgeting involves comparison of actual results with the standard ones. The unfavorable results are identified and removing the various difficulties of the projects helps for future selection and execution of the proposals.

SIGNIFICANCE OF CAPITAL BUDGETING:

- Capital budgeting is probably the most important single area of decision making for the finance manager in respect of planning the fund requirements and allocating the funds and controlling its uses. In capital budgeting, an estimate is made of an expenditure whose results will be available for a number of years and it takes long period of working before the final results of the action can be known.

- Thus, decision in respect of capital expenditure is going to affect the firm's operations for years to come. An erroneous forecast of assets can entail the firm in financial hardships. If a firm has invested too much in fixed assets, it will be incurring unnecessarily heavy expenses.

- If it has not spent enough on fixed assets, it may not be able to produce competitively since its equipment may not be sufficiently modern. Further, it may lose a portion of its share to rival firms. Further, an ill-advised decision cannot be rectified frequently without seriously affecting the health of the firm.

- Capital budgeting also saves the company from other problems which may otherwise arise. For instance, workers who were hired for the project might be laid off if the project fails, creating morale and unemployment problems. Many of the fixed costs will still remain even if a plant is closed or is not producing. Advertising efforts will be wasted. Stock prices could be affected by the decline in income.

- Another important reason for the importance of capital expenditure decision is that acquisition of fixed assets involves substantial expenditure. Before a firm spends a large amount of money, it must make the proper plans for raising large funds which cannot come automatically. A firm contemplating a major capital expenditure programme may need to arrange funds many years in advance to be sure of having the funds when needed.

- Capital budgeting provides useful tool with the help of which the management can reach prudent investment decision. It provides criterion of ranking investment project in terms of economic desirability. Projects yielding highest returns and involving less cost and risk may be given top priority.

- Capital budgeting provides quantitative evidence as to how much a firm should expand its total assets. This is provided by cut-off point—a point where marginal revenue and marginal cost equate. Not only is the capital budget a tool for decision making, it also acts as a planning and control device. As a planning tool, it helps the management to determine long-term capital requirements and timings of such requirements.

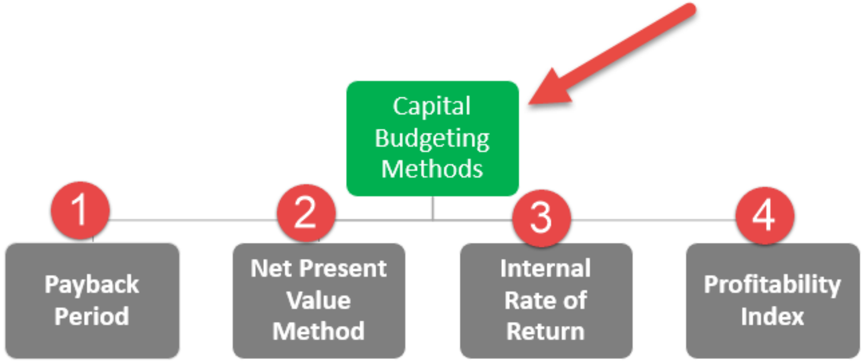
- Capital budget becomes a control device when it is employed to control expenditures. Planned outlays are limits to actual expenditure. The firm may also use the projected cash inflows and outflows as a standard with which to match the actual cash outflow and inflow of the capital budget. If costs deviate considerably, the company should investigate the variation in order to keep expenditure under control.

- In addition, other actions taken within the company regarding the project, such as finding suppliers of raw materials, are wasted if the capital-budgeting decision must later be revoked. Poor capital-budgeting decision may also harm the company’s competitive position because the company will not have the most efficient productive assets needed to compete in world market.

TECHNIQUE OF CAPITAL BUDGETING

Capital budgeting consists of various techniques used by managers such as:

- Payback Period
- Discounted Payback Period
- Net Present Value
- Accounting Rate of Return
- Internal Rate of Return
- Profitability Index



All of the above techniques are based on the comparison of cash inflows and outflow of a project however they are substantially different in their approach.

A brief introduction to the above methods is given below:

Payback Period measures the time in which the initial cash flow is returned by the project. Cash flows are not discounted. Lower payback period is preferred.

Net Present Value (NPV) is equal to initial cash outflow less sum of discounted cash inflows. Higher NPV is preferred and an investment is only viable if its NPV is positive.

Accounting Rate of Return (ARR) is the profitability of the project calculated as projected total net income divided by initial or average investment. Net income is not discounted.

Internal Rate of Return (IRR) is the discount rate at which net present value of the project becomes zero. Higher IRR should be preferred.

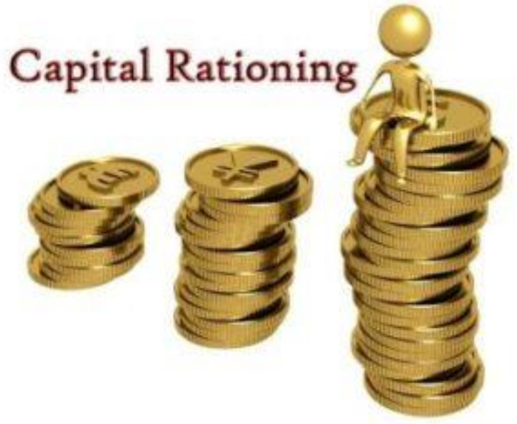
Profitability Index (PI) is the ratio of present value of future cash flows of a project to initial investment required for the project.

CAPITAL RATIONING

Capital rationing is defined as the process of placing a limit on the extent of new projects or investments that a company decides to undertake. This is made possible by placing a much higher cost of capital for the consideration of the investments or by placing a ceiling on a particular proportion of a budget. A company might intend to implement capital rationing in scenarios where the past revenues generated through investments were not up to the mark.

- Understanding Capital Rationing:

Capital rationing is necessarily an approach of management in allocating the funds available across various opportunities of investment, thereby enhancing the bottom line of the company. The company will go on the accept the blend of projects that have the net present value (NPV) on the higher side. The primary intention of the capital rationing is to make sure that a company is not going to invest heavily in assets. With insufficient rationing, a company may go on to witness the returns provided by their investments going on the lower side and may even reach a scenario where the company enter the stage of financial insolvency.



Types of Rationing:

The first type of capital rationing is called as the hard capital rationing. This type of rationing happens if a company is having issues with raising excessive funds, either by means of debt or equity. The rationing happens from an external dependence in order to cut down on expenses and may result in the shortage of capital to raise enough money for projects in future.

The second kind of capital rationing, is referred to as the soft capital rationing. It is also called as the internal rationing. This happens because of the internal policies of an organisation. A company that is financially conservative will have a high required return on the capital invested in taking up projects in the coming days, thereby imposing self capital rationing.

LEVERAGE

The word ‘leverage’, borrowed from physics, is frequently used in financial management.

The object of application of which is made to gain higher financial benefits compared to the fixed charges payable, as it happens in physics i.e., gaining larger benefits by using lesser amount of force.

- In short, the term ‘leverage’ is used to describe the ability of a firm to use fixed cost assets or funds to increase the return to its equity shareholders. In other words, leverage is the employment of fixed assets or funds for which a firm has to meet fixed costs or fixed rate of interest obligation—irrespective of the level of activities attained, or the level of operating profit earned.
- Leverage occurs in varying degrees. The higher the degree of leverage, the higher is the risk involved in meeting fixed payment obligations i.e., operating fixed costs and cost of debt capital. But, at the same time, higher risk profile increases the possibility of higher rate of return to the shareholders.

Some definitions are given to have a clear idea about leverage:

According to Ezra Solomon:

"Leverage is the ratio of net returns on shareholders equity and the net rate of return on capitalisation".

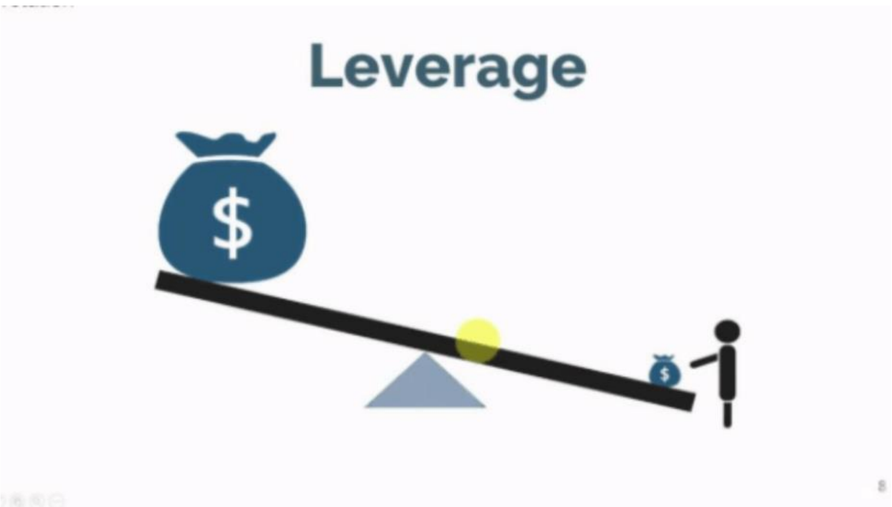
According to J. C. Van Home:

"Leverage is the employment of an asset or funds for which the firm pays a fixed cost of fixed return."

TYPES OF LEVERAGE

- **Leverage are the three types:**

 (i) Operating leverage
 (ii) Financial leverage and
 (iii) Combined leverage



Operating Leverage:

Operating leverage refers to the use of fixed operating costs such as depreciation, insurance of assets, repairs and maintenance, property taxes etc. in the operations of a firm. But it does not include interest on debt capital. Higher the proportion of fixed operating cost as compared to variable cost, higher is the operating leverage, and vice versa.

Financial leverage

Financial leverage which is also known as **leverage** or trading on equity, refers to the use of debt to acquire additional assets. The use of **financial leverage** to control a greater amount of assets (by borrowing money) will cause the returns on the owner's cash investment to be amplified.

combined leverage

Combined leverage is a **leverage** which refers to high profits due to fixed costs. It includes fixed operating expenses with fixed financial expenses. It indicates **leverage** benefits and risks which are in fixed quantity.