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# FINANCIAL MANAGEMENT

Text, Problems and Cases

7e

**M Y Khan**  
**P K Jain**

**Mc  
Graw  
Hill**  
Education



(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 decisions 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 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 1 Foundation of Finance

- Chapter 1 FINANCIAL MANAGEMENT—AN OVERVIEW
- Chapter 2 TIME VALUE OF MONEY
- Chapter 3 RISK AND RETURN
- Chapter 4 VALUATION OF BONDS AND SHARES

THIS PART OF THE BOOK DWELLS ON THE FOUNDATIONS OF FINANCE. CHAPTER 1 GIVES AN OVERVIEW OF FINANCIAL MANAGEMENT IN TERMS OF ITS RELATIONSHIP WITH RELATED DISCIPLINES, SCOPE, OBJECTIVES, AGENCY PROBLEM, ORGANISATION OF FINANCE FUNCTIONS IN A TYPICAL ORGANISATION AND THE ORGANISATION OF FINANCE FUNCTION IN INDIA. CHAPTER 2 DISCUSSES A BASIC FINANCIAL CONCEPT, NAMED, TIME VALUE OF MONEY. IT EXPLAINS AND ILLUSTRATES THE BASIC CONCEPTS AND DISCOUNTING TECHNIQUES AS WELL AS THEIR APPLICATIONS. WHILE RISK AND RETURN INCLUDING MULTIVARIATE AND FACTOR VALUATION IS ANALYSED IN CHAPTER 3, VALUATION OF BONDS AND SHARES IS COVERED IN CHAPTER 4.

## Part Preview

Each part begins with an overview that provides a glimpse of the contents in its chapters.

## Margin Notes

Important concepts and key terms are briefly summarised in the notes given in the margins.

predictable cash inflows can operate with little or no NWC. But where cash inflows are uncertain, it will be necessary to maintain current assets at a level adequate to cover current liabilities, that is, there must be NWC.

**Alternative Definition of NWC** NWC can alternatively be defined as that part of the current assets which are financed with long-term funds. Since current liabilities represent sources of short-term funds, as long as current assets exceed the current liabilities, the excess must be financed with long-term funds.

**Concept of Zero Working Capital!** The zero working capital (ZWC) concept of net working capital differs from the commonly used concept of working capital (CA - CL). The ZWC = Investments (I) Receivables (R) Payables. The rationale is that investments and receivables are the major constituents of current assets which are fixed assets. Further, supplies finance investment through account payables.

There are financial benefits of reducing the working capital. First, it results in a cost-time release of cash flow. Second, the release of cash enhances the firm's earnings. Put differently, permanent reduction in working capital funds provides the firm with funds (having no capital cost). The zero working capital concept forces the firm to produce and deliver faster. This, in turn, may help to gain new business. With low inventories, storage cost as well as loss due to obsolete inventories are also reduced, leading to another set of savings in operating costs. Just-in-time method of inventory control (discussed in Chapter 16) involves carrying relatively low level of raw-material inventories. Efficient production system (production in time with which can further help in reducing work-in-process and finished goods inventories).

In many, however, it may not be possible for most firms to operate at zero working capital. Yet, the concept is important as it focuses that the firm should strive for carrying minimum safety stock of inventory, pursuing good trade reduction policies leading to minimum investment in debtors and bargaining for maximum credit payment period from suppliers. These measures would result in financial and production economies, leading to higher return on investment.

**Policies Related to Current Assets Investment** There are three alternative policies related to the total amount of investments made in current assets: (1) **Relaxed**, (2) **Aggressive** and (3) **Moderate**. These policies differ in respect of the total amount of current assets carried to support a given level of sales. As a result, these policies have an impact on current assets turnover ratio.

**Relaxed Current Assets Investment Policy** This refers to the policy where the firm carry relatively large amount of cash and cash-equivalents, inventories and receivables. They use liberal credit policy implying relatively longer time-span of credit period extended to debtors, as a means of promoting sales (explained in Chapter 15). In view of the relatively higher amount of investment in current assets, the current assets turnover ratio of such firms tend to be relatively low.

**Aggressive Current Assets Investment Policy** This refers to the policy where the firm's holdings of cash and cash-equivalents, inventories and receivables are minimised. Since there is relatively lower amount of current assets to support given level of sales, the current assets turnover ratio tends to be high. Under such a policy, the firm would hold minimum level of safety stocks of cash and inventories, and would pursue a tight credit policy for credit sales (though at times, it runs the risk of losing sales). An aggressive credit policy implies minimum cash-in-hand, receivables and inventories.

# Chapter 1 Financial Management—An Overview

## Learning Objectives

1. Define finance and describe its major areas—financial management, financial management, financial corporate finance and financial services.
2. Differentiate financial management from the closely-related disciplines of accounting and economics.
3. Describe the scope of financial management and identify the key activities of the financial manager.
4. Explain why wealth-maximisation, rather than profit/EPS maximisation, is the goal of financial management and how economic value added (EVA) and focus on shareholders relate to its achievement and summarise the major objectives of corporate finance by Indian corporates.
5. Discuss the agency problem/issue as it relates to owners wealth maximisation.
6. Outline the progression of finance function and the emerging role of finance managers in India.

## INTRODUCTION

Finance may be defined as the art and science of managing money. The major areas of finance are: (1) financial services and (2) managerial finance/corporate finance/financial management. While financial services is concerned with the design and delivery of advice and financial products to individuals, insurance and government within the areas of banking and related institutions, personal financial planning, investment, real estate, insurance and so on, financial management is concerned with the activities of the financial managers in the business firm. Financial managers actively manage the financial affairs of any type of business, namely, financial and non-financial, private and public, large and small, profit-making and not-for-profit. They perform such varied tasks in budgeting, financial forecasting, cash management, credit

Finance is the art and science of managing money. Financial services is concerned with the design and delivery of advice and financial products to individuals, insurance and government within the areas of banking and related institutions, personal financial planning, investment, real estate, insurance and so on, financial management is concerned with the activities of the financial managers in the business firm. Financial managers actively manage the financial affairs of any type of business, namely, financial and non-financial, private and public, large and small, profit-making and not-for-profit. They perform such varied tasks in budgeting, financial forecasting, cash management, credit

## Learning Objectives

At the beginning of each chapter, the learning objectives outline what all the reader has to know when the chapter is completed.

fact) acceptable as it adds Rs 90,000 as profit. However, when we take into account a rate of interest, say, of 10 per cent, the earlier conclusion will have to be revised as, without the project, the sum could have amounted to Rs 1,10,000. Likewise, when the decision is made to raise a loan of Rs 10,00,000 from a financial institution or by issuing debentures, for a period of 10 years, the firm is not only under obligation to meet interest payment as and when it becomes due on the debt at fixed intervals but also must make provisions so that it can repay Rs 10,00,000 when the loan or debentures become due. Thus, time value of money is of crucial significance. This requires the development of procedures and techniques for equating future incomes in terms of the present.

## SECTION 2 TECHNIQUES

The preceding discussion has revealed that in order to have logical and meaningful comparisons between cash flows that result in different time periods it is necessary to convert the sums of money to a common point in time. There are two techniques for doing this: (1) Compounding, and (2) Discounting.

### Compounding Technique

Interest is compounded when the amount earned on an initial deposit (the initial principal) becomes part of the principal at the end of the first compounding period. The term principal refers to the amount of money on which interest is received. (Consider Example 2.1.)

#### Example 2.1

If Mr. X invests in a saving bank account Rs 1,000 at 5 per cent interest compounded annually, at the end of the first year, he will have Rs 1,050 in his account. This amount becomes the principal for earning interest for the next year. At the end of the next year, there would be Rs 1,102.50 in the account. This would represent the principal for the third year. The amount of interest earned would be Rs 52.25. The final amount appearing in his account would be Rs 1,157.025. Table 2.1 shows this compounding procedure.

TABLE 2.1 Annual Compounding

Year	1	2	3
Beginning amount	Rs 1,000.00	Rs 1,050.00	Rs 1,102.500
Interest rate	0.05	0.05	0.050
Amount of Interest	50.00	52.50	56.125
Beginning principal	1,000.00	1,050.00	1,102.500
Ending principal	1,050.00	1,102.50	1,157.025

This compounding procedure will continue for an indefinite number of years. The compounding of interest can be calculated by the following equation:

$$A = P(1 + i)^n \quad (2.1)$$

- \* in which
- A = amount at the end of the period
- P = principal at the beginning of the period
- i = rate of interest
- n = number of years

Compound interest is the interest earned on a given deposit principal that has become a part of the principal at the end of a specified period.

Principal refers to the amount of money on which interest is received.

## Examples

Solved examples help in the better understanding of concepts.



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