**SEMESTER** – **B.Com,** **SEMESTER 6**

**SUBJECT** – **FINANCIAL MANAGEMENT**

**NAME OF THE TEACHER – DEEPASHREE CHATTERJEE**

**LECTURE NO. – 1**

We have so far understood what Financial Management means, what are the important functions of a finance manager and the important decisions that needs to be taken by him. We have also understood important concepts like operating risks, financial risks, margin money, etc.

We have discussed in details the different sources of raising finance, the pros and cons of raising funds from each of these sources and how the decision about which sources to raise funds or basically deciding on the optimum capital structure is important. Once the funds are raised, the next important decision is the investment of these funds in procuring assets of the firm, which will be dealt in details in the present chapter ‘capital budgeting’.

**INTRODUCTION TO CAPITAL BUDGETING**

A firm invests in assets to continue to exist, and moreover, to grow. By investing to grow, a firm is at the same time investing to maximize the owners' wealth. To maximize the wealth of a firm's owners, its managers must regularly evaluate investment opportunities and determine which ones provide a return commensurate with their risk.

Firms continually invest funds in assets and these assets produce income and cash flows that the firm can then either reinvest in more assets or pay to its owners. These assets represent the firm's capital. Thus capital is the firm's total assets and is comprised of all tangible and intangible assets. These assets include physical assets (such as land, buildings, equipment, and machinery), as well as assets that represent property rights (such as accounts receivable, notes, stocks, and bonds). When we refer to capital investment, we are referring to the firm's investment in its assets.

The term "capital" in financial management, a firm's resources and the funds committed to these resources, does not mean the same thing in other fields. In accounting, the term "capital" means the owners' equity, the difference between the amount of a firm's assets and its liabilities. In economics, the term "capital" means the physical (real) of the firm, and therefore excludes the assets that represent property rights. In law the term "capital" refers to the amount of owners' equity required by statute for the protection of creditors. This amounts to the "stated capital", which often is the par value of the firm's stock.

The firm's capital investment decision may be comprised of a number of distinct decisions, each referred to as a project. A capital project is a set of assets that are contingent on one another and are considered together. Suppose a firm is considering the production of a new product. It must make a decision of whether or not to produce this new product. This capital project entails acquiring land, building facilities, and purchasing production equipment. And this project may also require the firm to increase its investment in its working capital -- inventory, cash, or accounts receivable. Working capital is the collection of assets needed for day-to-day operations that support a firm's long-term investments.

The investment decisions of the firm are decisions concerning a firm's capital investment. When we refer to a particular decision that financial managers must make, we are referring to a decision pertaining to a capital project.

Thus, capital budgeting is the process of identifying and selecting investments in long-lived assets, where long-lived means assets expected to produce benefits over more than one year.

**Important terms**

**Project Life** – A project life refers to the time period in which the project is expected to start and ends when the project is discontinues. It is generally divided in years as Y1, Y2, Y3, etc.

**Discounting rate or hurdle rate -** A project's business risk is reflected in the discount rate, which is the rate of return required to compensate the suppliers of capital (bondholders and owners) for the amount of risk they bear. From investors' perspective, the discount rate is the *required rate of return* (RRR). From the firm's perspective, the discount rate is the *cost of capital* -- what it costs the firm to raise a rupee of new capital.

**Time Value of money –** The amount of rupees required to buy a product today might not be equal to the amount required to buy it tomorrow, because the value of money keeps decreasing with time because of various factors like inflation etc. The same pencil which used to be available at Re 1 ten years back, would now be available for Rs 4. Hence, m**oney in the present is worth more than the same sum of money to be received in the future**. This concept is known as the time value of money.

**Cash inflow** – The cash inflow from the project are compared with the cash outflow to decide the most profitable venture. Operating cash inflows are calculated using the following formula:

1. **Operating cash flow** = Net income + Non-cash expenses (eg depreciation)\* – Increases in working capital
2. **Discounted cash flow (DCF)** = Sum of cash flow in period ÷ (1 + Discount rate) ^ Period number

\* Depreciation itself is not a cash flow. But in determining cash flows, we are concerned with the effect depreciation has on our taxes -- and we all know that taxes are a cash outflow. Since depreciation reduces taxable income, depreciation reduces the tax outflow, which amounts to a cash inflow.

**CAPITAL BUDGETING**

The Five Stages in the Capital Budgeting Process

1. INVESTMENT SCREENING AND SELECTION.

Projects consistent with the corporate strategy are identified. But projects don't simply walk into corporate headquarters. The firm must have some system for seeking or generating investment opportunities. Identifying investment opportunities is not necessarily the task of the financial manager. This task typically lies with the production, marketing, and research and development management of the firm.

2. THE CAPITAL BUDGET PROPOSAL.

A capital budget is proposed for the projects surviving the screening and selection process. The budget lists the recommended projects and the dollar amount of investment needed for each. This proposal may start as an estimate of expected revenues and costs, but as the project analysis is refined, data from marketing, purchasing, engineering, accounting, and finance functions are collected and put together.

3. BUDGETING APPROVAL AND AUTHORIZATION.

Projects included in the capital budget are authorized, allowing further fact gathering and analysis, and approved, allowing expenditures for the projects. In some firms, the projects are authorized and approved at the same time. In others, a project must first be authorized, requiring more research before it can be formally approved.Formal authorization and approval procedures are typically used on larger expenditures; smaller expenditures are at the discretion of management.

4. PROJECT TRACKING.

After a project is approved, work on it begins. The manager reports periodically on its expenditures, as well as on any revenues associated with it. This is referred to as project tracking, the communication link between the decision makers and the operating management of the firm. For example: tracking can identify cost over-runs; it can also identify that more marketing research is needed to better focus on the target market.

5. POST-COMPLETION AUDIT.

Following a period of time, perhaps two or three years after approval, projects are reviewed to see whether they should be continued. This re evaluation is referred to as a post-completion audit. Thorough post completion audits are not usually performed on every project since that would be too time consuming. Rather, they are performed on selected projects, usually the largest projects in a given year's budget for the firm or for each division. Post-completion audits enable the firm's management to see how well the cash flows realized correspond with the cash flows forecasted several years earlier.