# Financial Management

#### Ashish Kumar Sana

Professor, Department of Commerce University of Calcutta

#### **Bappaditya Biswas**

Assistant Professor, Department of Commerce University of Calcutta

#### **Swapan Sarkar**

Assistant Professor, Department of Commerce University of Calcutta

#### Samyabrata Das

Associate Professor of Commerce, New Alipore College Kolkata



### McGraw Hill Education (India) Private Limited

**CHENNAI** 

McGraw Hill Education Offices

Chennai New York St Louis San Francisco Auckland Bogotá Caracas

Kuala Lumpur Lisbon London Madrid Mexico City Milan Montreal

San Juan Santiago Singapore Sydney Tokyo Toronto

## **Contents**

Preface		vii
Acknowledgi	ments	viii
Syllabus of L	Iniversity of Calcutta B.Com. Hons. in Accounting & Finance	ix
Chapter 1	Introduction	1.1–1.17
	1.1 Introduction 1.1	
	1.2 Definition of Financial Management 1.2	
	1.3 Stages of Evolution of Financial Management 1.2	
	1.3.1 Traditional Phase (During 1920s–1930s) 1.2	
	1.3.2 Transitional Phase (From 1930s till 1950s) 1.3	
	1.3.3 Modern Phase (Early 1950s) 1.3	
	1.4 Nature of Financial Management 1.3	
	1.5 Objectives of Financial Management 1.4	
	1.6 Scope or Functions of Financial Management 1.5	
	1.7 Interrelation of Financing, Investment and Dividend Decision	1.7
	1.8 Objective of the Firm—Profit Maximisation vs. Wealth	
	Maximisation 1.7	
	1.8.1 Profit Maximisation 1.8	
	1.8.2 Wealth Maximisation 1.10	
	1.8.3 Profit Maximisation vs. Wealth Maximisation 1.12	
	1.8.4 Wealth Maximisation Depends on Profit Maximisation	1.12
	1.9 Role/Functions of a Chief Financial Officer 1.13	
	1.10 Emerging Role of Financial Manager/CFO in India 1.15	
	1.11 Summary 1.16	
	Exercises 1.17	
Chapter 2	Basic Concepts: Time Value of Money	2.1-2.44
	2.1 Introduction 2.1	
	2.2 Time Value of Money 2.1	
	2.2.1 Concept of Time Value of Money 2.3	
	2.2.2 Timeline and Notation 2.3	
	2.2.3 Reasons for Time Preference of Money 2.5	
	2.2.4 Importance of Time Value of Money 2.6	
	2.2.5 Concept of Rate of Interest 2.6	
	2.2.6 Comparison of Simple and Compound Interest 2.9	
	2.2.7 Doubling Period 2.10	

2.3	Techniques of Time Value of Money 2.11 2.3.1 Discounting or Present Value Method 2.11 2.3.2 Compounding or Future Value Method 2.16 2.3.3 Distinction between Compounding and Discounting Methods 2.20	
2.4	Annuity 2.21	
	2.4.1 Present Value of an Annuity 2.22	
	2.4.2 Future Value of an Annuity 2.24	
2.5	Perpetuity 2.27	
2.6	Risk 2.29	
	2.6.1 Types of Risk 2.29	
	2.6.2 Measurement of Risk 2.30	
2.7	Return 2.32	
	2.7.1 Measurement of Return 2.32	
	Risk-Return Relationship 2.34	
	Risk-Return Trade-off 2.34	
2.10	Financial Environment 2.35	
	Summary 2.38	
Exer	cises 2.39	
Chapter 3 Source	es of Finance and Cost of Capital	3.1-3.84
3.1	Sources of Finance 3.1	
3.2	Financial Needs of a Business 3.1	
3.3	Classification of Sources of Finance 3.2	
	3.3.1 Based on the Period 3.2	
	3.3.2 Based on Ownership 3.2	
	3.3.3 Based on Sources of Generation 3.3	
	3.3.4 Based on the Mode of Finance 3.3	
3.4	Long-term Sources of Finance 3.3	
	3.4.1 Equity Share 3.3	
	3.4.2 Preference Shares 3.8	
	3.4.3 Debentures	
	3.4.4 Institutional Financing 3.13	
	3.4.5 Lease Financing 3.16	
	3.4.6 Term Loans 3.18	
	3.4.7 Internal Finance 3.18	
	3.4.8 International Sources 3.20	
3.5	Short-term Sources of Finance 3.21	
	3.5.1 Trade Credit	
	3.5.2 Accrued Expenses 3.21	

	3.5.3 Commercial Papers 3.22	
	3.5.4 Inter-corporate Deposits 3.22	
	3.5.5 Short-term Unsecured Debentures 3.23	
	3.5.6 Bank Credit 3.23	
	Cost of Capital—Concept and Definition 3.23	
	Importance/Significance/Relevance of Cost of Capital 3.24	
	Factors Determining Cost of Capital 3.25	
3.9	Different Types of Cost of Capital 3.26	
	3.9.1 Explicit and Implicit Cost 3.26	
	3.9.2 Specific Cost and Composite Cost 3.27	
	3.9.3 Average Cost and Marginal Cost 3.27	
2.10	3.9.4 Historical Cost and Future Cost 3.27	
3.10	Determination of Cost of Capital 3.28	
	3.10.1 Cost of Long-term Debt 3.28	
	3.10.2 Cost of Preference Share Capital 3.35	
2 11	3.10.3 Cost of Equity Shares 3.38	
3.11	Weighted Average Cost of Capital or Overall Cost of Capital 3.5	2
2.10	3.11.1 Steps Taken for Calculation of WACC 3.52	
	Marginal Cost of Capital 3.59 Additional Solved Problems 3.64	
	Summary 3.78 vcises 3.81	
Chapter 4A Lever		- 4A.42
	Introduction 4A.1	
	Business Risk 4A.1	
	Financial Risk 4A.2	
4A.4	Leverage 4A.2	
	4A.4.1 Meaning 4A.2	
	4A.4.2 Concept of Operating Leverage 4A.3	
	4A.4.3 Concept of Financial Leverage 4A.8	
	4A.4.4 Concept of Combined Leverage 4A.12	
	4A.4.5 Selection of Financing Plans based on Leverage 4A.13	
	4A.4.6 Concept of EBIT-EPS Analysis 4A.14	
	4A.4.7 Indifference Point 4A.16	
4 4 5	4A.4.8 Financial Break-Even Point 4A.17	
	Concept of Trading on Equity 4A.18	
	Additional Solved Problems 4A.18	
	Summary 4A.34	
Exerc	cises 4A.35	

Chapter 4B	Capital Structure Decisions	4B.1-4B.55
	4B.1 Introduction 4B.1	
	4B.2 Concept of Capital Structure 4B.1	
	4B.3 Definition of Capital Structure 4B.2	
	4B.4 Capitalisation and Capital Structure 4B.2	
	4B.5 Financial Structure vs. Capital Structure 4B.3	
	4B.6 Classification of Capital Structure 4B.3	
	4B.7 Importance of Capital Structure 4B.6	
	4B.8 Factors Determining Capital Structure 4B.8	
	4B.8.1 Internal Factors 4B.8	
	4B.8.2 External Factors 4B.9	
	4B.9 Optimum Capital Structure 4B.10	
	4B.9.1 Features of Optimum Capital Structure 4B.11	
	4B.10 Capital Structure and Trading on Equity 4B.11	
	4B.10.1 Classification of Trading on Equity 4B.13	
	4B.10.2 Advantages and Disadvantages of Trading on Equi	ty 4B.14
	4B.11 Capitalization; Undercapitalization and Overcapitalization	4B.14
	4B.11.1 Capitalisation 4B.14	
	4B.11.2 Overcapitalisation 4B.16	
	4B.11.3 Undercapitalisation 4B.18	
	4B.12 Main Contentions of Capital Structure Theories 4B.20	
	4B.12.1 General Assumptions of Capital Structure Theories	4B.20
	4B.12.2 Different Capital Structure Theories 4B.20	
	4B.12.3 Net Income Approach 4B.21	
	4B.12.4 Net Operating Income Approach 4B.24	
	4B.12.5 Traditional Approach 4B.28	
	4B.12.6 Modigliani and Miller Hypothesis 4B.31	
	4B.13 Implications of Corporate Tax on Capital Structure Theories	
	4B.13.1 Modigliani-Miller Hypothesis and Corporate Taxat	
	4B.13.2 Net Income Approach and Corporate Taxation 4B	
	4B.13.3 Net Operating Income Approach and Corporate Tax	ation 4B.36
	4B.14 Additional Solved Problems 4B.38	
	4B.15 Summary 4B.50	
	Exercises 4B.52	
Chapter 5	Working Capital Management (I)	5.1-5.70
	5.1 Introduction 5.1	
	5.2 Concept and Meaning of Working Capital 5.2	

5.3 Constituents of Working Capital 5.2

	5.4 Types of Working Capital 5.3
	5.5 Nature and Objectives of Working Capital Management 5.6
	5.5.1 Nature of Working Capital Management 5.6
	5.5.2 Objectives of Working Capital Management 5.7
	5.6 Importance of Working Capital 5.8
	5.7 Effects of Excessive Working Capital 5.9
	<ul><li>5.8 Factors Determining Working Capital Requirement 5.10</li><li>5.9 Concept of Operating Cycle 5.12</li></ul>
	1 1 0 ,
	<ul><li>5.10 Methods of Determining Operating or Working Capital Cycle 5.14</li><li>5.11 Causes behind Longer Working Capital or Operating Cycle 5.18</li></ul>
	5.12 Strategies for Minimisation of Length of Working Capital Cycle or
	Operating Cycle 5.19
	5.13 Summary <i>5.57</i>
	Exercises 5.58
Chapter 6	Working Capital Management (II) 6.1– 6.66
Chapter	6.1 Source of Finance to Meet Working Capital Requirement 6.1
	6.1.1 Different Sources of Working Capital 6.1
	6.2 Financing Current Assets: Strategies of Financing 6.7
	6.2.1 Working Capital Policies in Relation to Sales 6.7
	6.2.2 Alternative Strategies of Financing 6.8
	6.2.3 Difference Between Conservative and Aggressive Strategies of
	Financing Current Assets 6.12
	6.3 Bank Financing—Recommendations of Tandon Committee and Chore
	Committee 6.13
	6.3.1 Tandon Committee 6.14
	6.3.2 Chore Committee 6.19
	6.4 Management of Cash 6.21
	6.4.1 Objectives and Need of Cash Management 6.22
	6.4.2 Reasons for Cash Surplus 6.22
	6.4.3 Reason for Cash Deficit 6.23
	6.4.4 Motives for Holding Cash 6.24
	6.4.5 Efficient Cash Management 6.25
	6.4.6 Cash Management Models 6.29
	6.4.7 Cash Budget as a Tool for Efficient Cash Management 6.35
	6.4.8 Recent Developments in Cash Management 6.36
	6.5 Receivables Management 6.37
	6.5.1 Types of Credit 6.38

Chapter 7

6.5.2 Objectives of Receivable Management 6.38	
6.5.3 Granting Credit to Customers 6.39	
6.5.4 Financing Receivables 6.40	
6.5.5 Costs Involved in Receivable Management 6.41	
6.5.6 Factors Affecting the Size of Receivables 6.42	
6.5.7 Policies for Managing Accounts Receivable 6.43	
6.5.8 Debtors Payment Terms 6.45	
6.5.9 Forming of Credit Policy 6.45	
6.5.10 Extending Credit Period: Profitability 6.47	
6.5.11 Introduction of Cash Discount 6.47	
6.6 Inventory Management 6.53	
6.6.1 Types of Inventory 6.54	
6.6.2 Benefits of Holding Inventories 6.54	
6.6.3 Costs Associated with Inventories 6.55	
6.6.4 Importance of Inventory Management 6.57	
6.6.5 Objectives of Inventory Management 6.58	
6.7 Tools and Techniques of Inventory Management 6.58	
6.7.1 Determination of Stock Level 6.59	
6.7.2 Economic Order of Quantity 6.60	
6.7.3 A-B-C Analysis 6.62	
6.7.4 V-E-D Analysis 6.63	
6.7.5 Just In Time (JIT) Inventory Control System 6.63	
6.7.6 Inventory Turnover Ratio 6.64	
6.8 Summary <i>6.64</i>	
Exercises 6.65	
Capital Expenditure Decision (I) 7.1–7.	25
7.1 Concept of Capital Budgeting 7.1	
7.2 Significance/Importance of Capital Budgeting 7.2	
7.3 Objectives of Investment Decisions 7.3	
7.4 Capital Budgeting Process 7.4	
7.5 Types of Projects 7.5	
7.6 Types of Capital Investment Decisions 7.6	
7.6.1 On the Basis of Decision Situation 7.6	
7.6.2 On the Basis of Firm's Existence 7.7	
7.7 Project Cash Flow 7.8	
7.7.1 Depreciation as a Tax Shield 7.8	
7.7.2 Component of Cash Flows 7.8	

	7.8 Basic Principles for Measuring Project Cash Flows 7.11	
	7.8.1 Post-tax Principle 7.11	
	7.8.2 Incremental Principle 7.11	
	7.8.3 Exclusion of Financing Costs Principle 7.12	
	7.8.4 Long Term Funds Principles 7.12	
	7.9 Techniques of Decision Making 7.12	
	7.9.1 Traditional or Non-Discounted Cash Flow Approaches	7.13
	7.10 Summary 7.23	, ,,10
	Exercises 7.24	
Chapter 8	Capital Expenditure Decision (II)	8.1-8.74
<b>F</b>	8.1 Time Adjusted or Discounted Cash Flow Techniques 8.1	
	8.1.1 Net Present Value Method 8.1	
	8.1.2 Profitability Index Method 8.9	
	8.1.3 Internal Rate of Return Method 8.12	
	8.1.4 Modified Internal Rate of Return 8.23	
	8.1.5 Terminal Value Method 8.24	
	<ul><li>8.1.6 Discounted Payback Period Method 8.26</li><li>8.1.7 Capital Budgeting Decisions in case of Projects with</li></ul>	
	Unequal Lives 8.28	
	8.2 Capital Rationing 8.29	
	1	
	8.2.1 Types of Capital Rationing Decisions 8.29 8.3 Additional Solved Problems 8.33	
	8.4 Summary 8.64	
	Exercises 8.64	0.1.0.00
Chapter 9	Dividend Decisions	9.1–9.39
	9.1 Introduction 9.1	
	9.2 Concept of Dividend 9.1	
	9.3 Nature of Dividend 9.2	
	9.4 Types of Dividend 9.5	
	9.5 Determinants of Dividend 9.6	
	9.6 Dividend Theories 9.8	
	9.6.1 Walter's Model on Dividend 9.9	
	9.6.2 Gordon's Model on Dividend 9.13	
	9.6.3 Modigliani and Miller (M-M) Model 9.15	
	9.6.4 Residual Theory of Dividend 9.20	
	9.7 Additional Solved Problems 9.21	
	9.8 Summary 9.34	
	Exercises 9.35	

Chapter 10	Financial Control	10.1–10.11
	10.1 Concept of Financial Control 10.1	
	10.2 Objectives of Financial Control 10.1	
	10.3 Steps of Financial Control 10.2	
	10.4 Major Tools of Financial Control 10.2	
	10.4.1 Budgetary Control 10.2	
	10.4.2 Return on Investment 10.3	
	10.4.3 Break-Even Analysis 10.4	
	10.4.4 Ratio Analysis 10.6	
	10.4.5 Zero-Based Budgeting 10.7	
	10.5 Advantages/Importance/Significance of Financial	
	Control System 10.8	
	10.6 Limitations/Disadvantages/Drawbacks of Financial Contro	l
	System 10.8	10.0
	10.7 Essential Elements of an Effective Financial Control System	10.9
	10.8 Summary 10.9	
	Exercises 10.10	
Previous-Ye	ars Solved Questions (2006–2016) PYSQ.	1- PYSQ.93
Solved Que	stion Paper 2017 SQ	P.1– SQP.12
Appendices	$\mathbf{A}_{\mathbf{j}}$	pp.1–App.5