# A Study of Investment Function and Its Importance in the Modern Business Environment

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## Abstract

The efficient allocation of the capital is the most important function, in the modern time, of the management. It involves the decisions to commit the firm's funds to the long term assets. Such decisions are of considerable importance to the firm since they tend to determine, its value and size by influencing its growth, profitability and risk. The investment decisions of the firm are generally known as capital budgeting, or capital expenditure decisions. Capital budgeting decisions pertain to fixed or long term assets which by definition refers to assets which are in operation, and yield a return, over a period of time, usually, exceeding one year. They therefore, involve a current outlay or series of outlays of cash resources in return for an anticipated flow of future benefits. In other words, the system of capital budgeting is employed to evaluate expenditure decisions which involves current outlays but are likely to produce benefits over a period of time longer than one year. These benefits may be either in the form of increased revenue or reduced costs. Capital expenditure decisions, therefore, includes additions, disposition, modifications and replacement of fixed assets. The objectives of the present study are to understand the concept of finance function, its importance in selection of investment proposals, rational and types of investment decisions.

**Key-Words:** Capital budgeting, finance function, fixed assets, mutually exclusive investment, independent investment.

## Introduction

Financial management is a goal oriented activity. The efficient allocation of the capital is the most important function, in the modern time, of the management. It involves the decisions to commit the firm's funds to the long term assets. Such decisions are of considerable importance to the firm since they tend to determine, its value and size by influencing its growth, profitability and risk. The investment decisions of the firm are generally known as capital budgeting, or capital expenditure decisions. Capital budgeting decisions pertain to fixed or long term assets which by definition refers to assets which are in operation, and yield a return, over a period of time, usually, exceeding one year. They therefore, involve

a current outlay or series of outlays of cash resources in return for an anticipated flow of future benefits. In other words, the system of capital budgeting is employed to evaluate expenditure decisions which involves current outlays but are likely to produce benefits over a period of time longer than one year. These benefits may be either in the form of increased revenue or reduced costs. Capital expenditure decisions, therefore, includes additions, disposition, modifications and replacement of fixed assets.

The term capital budgeting is used interchangeably with capital expenditure decisions, capital expenditure management, long term investment decisions, management of fixed assets and so on. Thus it includes both raising of long term funds as well as their utilization. It may be thus defined as the firm's formal process for the acquisition and investment of capital. It is the decision making process by which the firm's evaluate the purchase of major fixed assets. However, it should be noted that investment in current assets necessitated on account of investment, in a fixed assets, is also to be taken as a capital budgeting decision. For example, a new distribution system may call for both a new warehouse and an additional investment in inventories. An investment proposal of this nature must be taken as a capital budgeting decision and evaluate as a single package not as an investment in a fixed assets (i.e., warehouse) and in a current assets (i.e., inventory) separately.

Capital budgeting is many sided activity. It includes searching for new and more profitable investment proposals, investigating engineering and marketing considerations to predict the consequences of accepting the investment and making economic analysis to determine the profit potentials of each investment proposal. Capital budgeting decisions pertain to fixed/ long term assets which by definition refer to assets which are in operation and yield a return over a period of time usually exceeding one year. A capital budgeting decision may be defined as the firm's decision to invest its current funds most efficiently in the long term assets in anticipation of an expected flow of benefits over a series of years The long term assets are those assets which affect the firm's operations beyond the one year period. The firm's investment decisions would generally include expansion, acquisition, modernization and replacement of the long term assets. Sale of a division or business (disinvestment) is also analyzed as an investment decision. Activities such as change in the method of sales distribution, or undertaking an advertising campaign or a research and development programme have long term implications for the firm's expenditure and benefits and therefore they may also be evaluated as investment decisions. It is important to note that investment in the long term assets invariably requires funds to be tied up in the

current assets such as inventories and receivables. As such investment in fixed and current assets is one single activity.

**Objectives of The Study**

The objectives of the present study are to understand the concept of finance function, its importance in selection of investment proposals, rational and types of investment decisions.

**Importance of Investment Decisions**

Capital budgeting decisions are among the most crucial and critical business decisions. Special care should be taken in making these decisions on account of the following reasons:

**Growth: -** The effects of investment decisions extend into the future and have to be endured for a longer period than the consequences of the current operating expenditure. Firm's decision to invest in long term assets has a decisive influence on the rate and direction of its growth. A wrong decision can prove disastrous for the continued survival of the firm; unwanted or unprofitable expansion of assets will results in heavy operating costs to the firm. On the other hand, inadequate investment in assets would make it difficult for the firm to compete successfully and maintain its market share.

**Risk: -** Long term commitment of funds may also change the risk complexion of the firm. If adoption of an investment increases average gain causes frequent fluctuations in its earnings, the firm will become more risky. Thus investment decisions shape the basic character of a firm.

**Funding: -** Investment decisions generally involve large amount of funds which make it imperative for the firm to plan its investment programmes very carefully and make advance arrangement for procuring finances internally and externally.

**Irreversibility: -** Most investment decisions are irreversible. It is difficult to find a market of such capital items once they have been acquired. The firm will incur heavy losses if such assets are scrapped.

**Complexity: -** Investment decisions are among the firm's most difficult decisions they are an assessment of future events which are difficult to predict. It is really a complex problem to correctly

estimate future cash flows of an investment. The cash flow uncertainty is caused by economic, political, social and technological forces.

**Expansion and Diversification**

A company can adds capacity to its existing product lines to expand existing operations. For example, a fertilizer company may increase its plant size to manufacture more urea. Expansion of new business requires investment in new products and a new kind of production activity within the firm. If a package manufacturing company invests in new plant and machinery to produce ball bearings, which the firm has not manufactured before this represents expansion of new business or diversification. Sometimes a company acquires existing firms to expand its business. In either case, the firm makes investment in the expectation of additional revenue. Investment in existing or new products may also be called as revenue-expansion investments.

**Replacement and Modernization**

The main objective of modernization and replacement is to improve operating efficiency and reduce costs. Cost saving will reflect in the increased profits, but the firm's revenue may remain unchanged. Assets become outdated and obsolete with technological changes. The firm must decide to replace those assets with new assets that operate more economically. If a cement company changes from semiautomatic drying equipment to fully automatic drying equipment, it is an example of modernization and replacement. Replacement decisions help to introduce more efficient and economical assets and therefore are also called cost-reduction investments. However, replacement decisions which involve substantial modernization and technological improvements expand revenue as well as reduce costs.

Yet another useful way to classify investments is as follows:

**Mutually Exclusive Investments**

It serves the same purpose and competes with each other. If one investment is undertaken, others will have to be excluded. A company may, for example, either use a more labor-intensive, semi-automatic machine, or employ a more capital-intensive, highly automatic machine for production. Choosing the semi-automatic machine precludes the acceptance of highly automatic machine.

**Independent Investments**

They serves different purpose and do not compete with each other. For example, a heavy engineering company may be considering expansion of its plant capacity to manufacture additional excavators and addition of new production facilities to manufacture a new product- light commercial vehicle. Depending on their profitability and availability of the funds, the company can undertakes both investments.

**Contingent Investments**

These are dependent projects; the choice of one investment necessitates that one or more other investments should also be undertaken. For example, if a company decides to build a factory in a remote, backward area, it may have to invest in houses, roads, hospitals, schools etc. for employees to attract the work force. Thus building of factory also requires investment in facilities for the employees. The total expenditure will be treated as one single investment.

**Rationale**

The rationale underlying the capital budgeting decisions is efficiency. Thus a firm must replace worn and obsolete plants and machinery, acquire fixed assets for current and new products and make strategic investment decisions. This will enable the firm to achieve its objective of maximizing profits either by way of increased revenue or cost reductions. The quality of these decisions is improved by capital budgeting. Capital budgeting decisions can be of two types:-

1. Those which expand revenues
2. Those which reduce costs.

**Investment Decisions Affecting Revenues**

Such investment decisions are expected to bring in additional revenue, thereby raising the size of the firm's total revenue. They can be the result of either expansion of present operations or the development of new product lines. Both types of investment decisions involve acquisition of new fixed assets and are income expansionary in nature in the case of manufacturing firms.

**Investment Decisions Reducing Costs**

Such decisions, by reducing costs, add to the total earnings of the firm. A classic example of such investment decisions are the replacement proposals when an asset wear out or become outdated. The firm must decide whether to continue with the existing assets or replace them. The firm evaluates the benefits from the new machine in terms of lower operating cost and outlay that would be needed to replace the machine. An expenditure on a new machine may be quite justifiable in the light of the total cost savings that result.

A fundamental difference between the above two categories of investment decisions lies in the fact that cost-reduction investment decisions are subject to less uncertainty in comparison to the revenue affecting investment decisions. This is so because the firm has a better feel for potential cost savings as it can examine past production and cost data. However it is difficult to precisely estimate the revenues and costs resulting from a new product line, particularly when the firm knows relatively little about the same.

**The Amount of Investment**

In case a firm has unlimited funds for investment it can accept all capital investment proposals which give a rate of return higher than the minimum acceptable or cut-off rate. However most firms have limited funds and therefore capital rationing has to be imposed. In such an event a firm can take only such project or projects which are within its means. In order to determine which project should be taken up on this basis, the projects should be arranged in an ascending order according to the amount of capital investment required.

**Minimum Rate of Return on Investmen**

The management expects a minimum rate of return on the capital investment. The minimum rate of return is usually decided on the basis of the cost of capital. For example, if the cost of capital is 10%, the management will not like to accept a proposal which yields a rate of return which is less than 10%. The projects giving a yield below the desired rate of return will, therefore, be rejected.

**Return Expected From the Investment**

Capital investment decisions are made in anticipation of increased return in the future. It is therefore very necessary to estimate the future return or benefits accruing from the investment proposal while

evaluating capital investment proposals. There are two criteria available for quantifying benefits from capital investment decisions. They are

(i) accounting profit

(ii) cash flows

The term accounting profit is identical with income concept used in accounting. While in estimating cash flows, depreciation charges and other amortization charges of fixed assets are not subtracted from gross revenue, because no cash expenditure is involved.

**Risk and Uncertainty**

Different capital investment proposals have different degree of risk and uncertainty. There is a slight difference between risk and uncertainty. Risk involves situation in which the probabilities of a particular event occurring are known, whereas in uncertainty, these probabilities are not known. Of course in most cases these two terms are used interchangeably. Risk in capital investment decisions may be due to general economic condition, competition, technological developments, cost and economic life of a particular investment are not certain. While evaluating capital investment proposals, a proper adjustment should therefore be made for risk and uncertainty.

Besides the above factors, various other non-monetary considerations should also be weighed before taking s capital investment decision. For example, if a new product is to be introduced in the market, its effect on the sale of existing product must also be seen. Sometimes a heavy investment completely changes the character of firm. It may be felt by the investors that the company has entirely changed its line of manufacture and it may adversely affect the image of the company. This may result in fall in the value of the company's shares in the stock exchange. In other words, all possible consequences must be seen and in no case the image of the company should be allowed to be lowered down.

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