

CO-OPERATE PLANNING PROCESS AND INVESTMENT DECISIONS

BY

IBRAHIM FARI OKEJI

Introduction

One of the most significant business decisions is that of project investment. It is the primary focus of shareholders' attention.

Companies which make things happen take ambitious project investment decisions with great care. An effectively handled planning process and carefully surged stages of capital investment decisions are the hallmarks of proactive firms, and the success rate of such companies is high. This chapter, therefore, first deals with definition and characteristics of project investment, and goes briefly describing the corporate planning processes involved. Various stages in project investment decisions have been described before being detailed under the heading of corporate investment decisions.

A project investment decision is a multi-stage relay marathon race. Capital budgeting, which can also be known as capital expenditure planning and control, forms part of it.

What is Capital Expenditure

Capital expenditure is a commitment of current resources in order to secure a stream of benefits in future years. This definition is a simple but apt description of the meaning of capital expenditure. Revenue expenditure would also qualify as capital expenditure under this definition. In general, only that capital outlay is considered as capital expenditure whose stream of benefits is expected to arrive over more than one year. Two factors are kept in mind while using the term 'capital expenditure' one, the **timing of benefits**, and two, the **size and type** of expenditure.

The value of benefits received is measured not only in terms of benefits received, but also the timing of their receipt. The value of time is recognized in assessing the worth of the project. The timing of benefits is duly considered through the choice of appropriate evaluation methods

The net benefits of capital expenditure depend upon the quality of investment decisions. The quality is judged through the weighing of benefits against the risks and uncertainties, if any. The net benefit of the project will be a function of, (a) the risks involved, (b) the ability to generate synergy, and (c) the firm's internal control and pro-activeness. A firm, which has set up an efficient mechanism for the study of project proposals will commit less estimation errors and possess a better knowledge of associated risks. New projects with good synergic benefits to a firm will be less risky. A high synergy yield in a project will emanate from clearly defined corporate vision, goals and effective strategic planning. Effective internal controls and quick response cycle during the project planning, execution and commissioning stages are necessary for achieving a high degree of success.

The size and type of capital expenditure are only supportive elements in the definition of capital expenditure. They are essential for both, designing of the administrative set up required for handling the capital budgeting exercise, and for building an effective control mechanism.

In short, expenditure is termed as capital expenditure when benefits accrue for more than one year, and the size of expenditure is large.

Characteristics of Capital Expenditure

Capital expenditure is different from revenue expenditure. Important characteristics, which distinguish capital expenditure from revenue expenditure, involve a sizeable amount of funds movement.

Long-term benefits: Benefits accrue from capital expenditure over a long period, and are usually of repetitive nature.

The risk element: Benefits from capital expenditure are subject to risk. Judgmental risks, estimation errors, data errors, and the unpredictability of events are usually present in any capital expenditure. The degree of risk may vary depending upon the project

High visibility: The noticeability of capital expenditure within and outside an organization is very high. The process of budgeting and allocating capital is of great concern to all parties involved.

Expensive mistakes: mistake in capital investment could prove very expensive. A wrong project decision could result in a continuous draining of resources, if continued. The subsequent abandoning of a project would involve the loss of a large sum invested as well as the loss of prestige, employee morale and investor confidence.

BASIC FRAMEWORK OF CORPORATE PLANNING PROCESS

The need for effective planning is the result of human greed and competition. Human ambition for material gain is easily attainable with a little planning, if there is not much competition. However, the pursuit of materialism needs meticulous and smart planning in the environment of fierce competition that exists today.

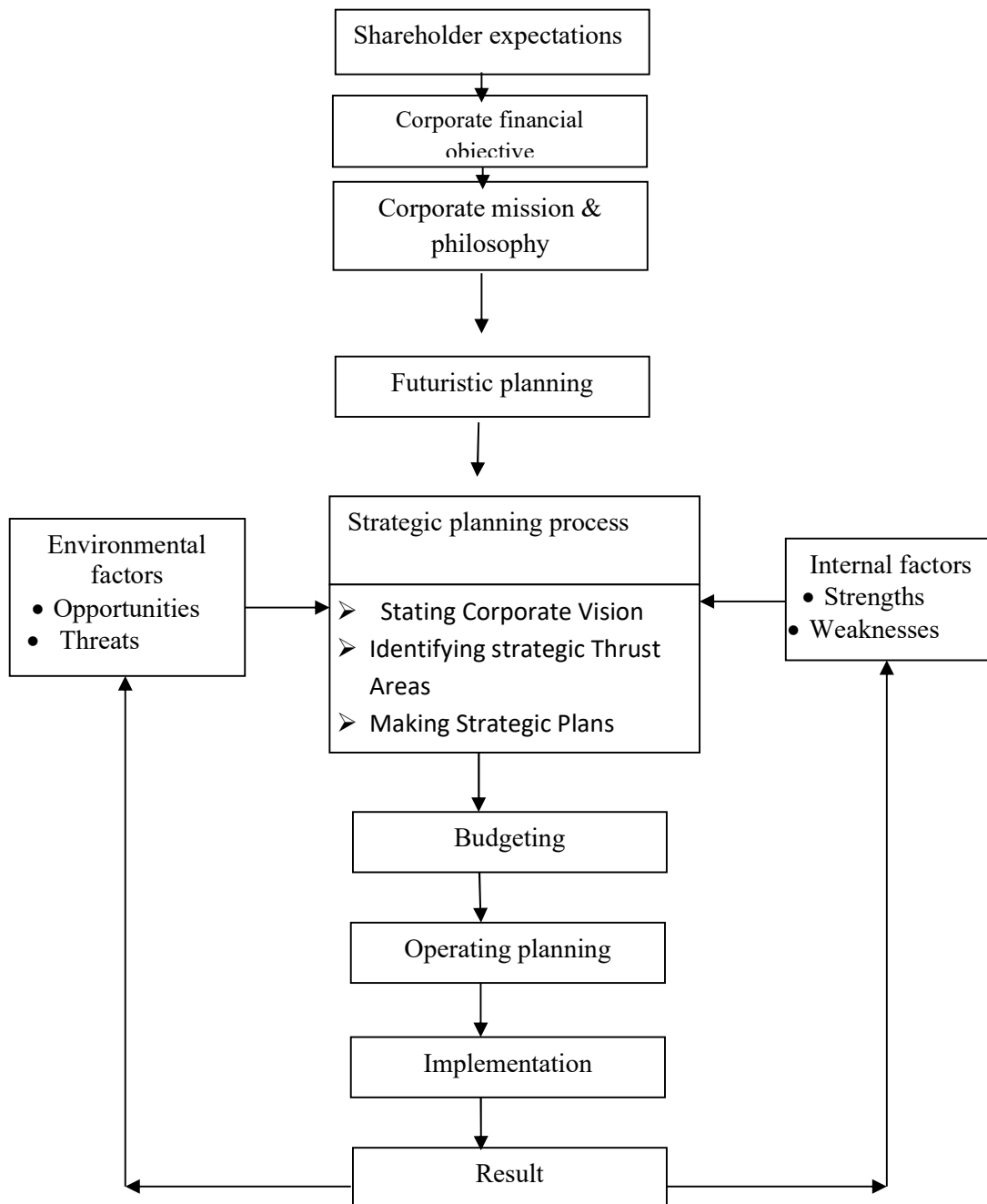


Fig 1.1 stages in the corporate planning process

The corporate planning process establishes a vital linkage of day-to-day functioning of the business with the expectations of shareholders. An effective planning process can convert seemingly unrealistic ambitions into an achievement. An effective planning process is carried out in many stages, which are depicted in the Fig 1.1, followed by their descriptions.

Corporate Financial Objectives

Companies are owned by shareholders and should therefore attempt to live up to their expectations. Corporate financial objectives should be in tune with shareholder expectations ‘shareholder wealth maximization’ is a widely accepted expression of corporate financial objectives. How has the corporate financial objective evolved over the period? What are the measures of wealth’ of shareholders? It would be appropriate to mention here that a firm, which offers maximum returns to its shareholders through the payment of dividends, distribution of bonus shares and ensures capital appreciation, meets shareholder expectations. Increasingly equity share prices comprehensively indicate wealth creation.

Corporate Mission and Philosophy

A well-defined mission and philosophy guide the ways of doing business. The value system of the firm (reflects the values of the promoters and) builds the image of the company. Quite a few firms observe very high ethical standards in doing business. They refuse to indulge in bribery, tax evasion, political alignments and undertake social development work, etc. mission and philosophy are the moral commitments of a firm to the community. A well-defined value system of a firm can build its public image, and help it acquire immunity against perils.

Futuristic Planning

This is an ambition building exercise and may appear to be only wishful thinking, quite far removed from reality. Futuristic plans are usually of twenty years duration or longer. One of Nigeria’s oil company initiated the process of making futuristic plans in 1990. The title of the exercise was “XYZ Company: 25 Years Hence”. The initiator of the exercise circulated a letter, inviting proposals of plans, which carried an opening statement, part of which is reproduced as follows:

“don’t limit your imagination by existing boundaries of geographic location and products”.

This is analogically the same as asking a small child the question ‘what would you like to become?’ this apparently meaningless questions when asked over time, creates a mind set in favour of having a purpose in life.

SWOT Analysis

Strategic plans, budgets and operating plans must be backed up by an analysis of the situation. An element of situation analysis makes plans realistic and achievable. A generic model of situation analysis is popularly known as SWOT analysis, where; S = Strength; W = Weakness; O – Opportunities; T = Threats Strength and weaknesses pertain to factors internal to the business. The external environment offer opportunities or poses threats. A careful and balanced study of opportunities, threat strengths and weaknesses help the process of efficient recourse allocation.

SWOT is neither a tool nor technique. It is an approach, therefore, a SWOT analysis could be based on certain preceptors. The following statements will serve to create a better understanding of SWOT analysis

1. SWOT is a perception
2. An apparent weakness of the firm may actually be a result of some strength. For example, better quality also means higher costs.
3. External or internal threats need not endanger chances of survival and growth. Co-survival with threatening factors is possible. It is not always necessary to fight a threat.
4. Everyone possesses certain weaknesses. All weaknesses need not be removed. One has to learn to live with many of them.
5. Remove selected weaknesses if they are likely to become an obstacle to survival and growth and simultaneously build strengths.

6. Oppose and vanquish threatening factors if they are likely to obstruct growth.
7. Identify those opportunities which can be tapped with the firm's strengths, and channelize the strengths in that direction.

A good understanding of the situation would be helpful in planning a viable fit between the firm's resources and changing opportunities. These firms stand a better chance of forming the winning habit.

Strategic Planning Process

This is the first stage of serious planning. It not only details goals, but also recognizes constraints. Kotler Philip provides a comprehensive definition of the strategic planning process as follows:

*“Strategic planning is the managerial process of developing and maintaining a viable fit between the organization's **objective** and **resources** (on one side), and its changing **opportunities** (on the other). The aim of strategic planning is to shape and reshape the company's business and products, so that they combine to produce satisfactory **profit and growth**”.*

The wordings “to shape and reshape the company's business and products” indicate that the product and geographical boundaries of the firm are less important than the attainment of laid out objectives.

The wordings “so that they combine to produce satisfactory profit and growth” lay emphasis on the dual goals of profit and growth. The words “developing and maintaining viable fit...” suggest that profit and growth come in phases. A growth phase must be consolidated for profit before surging ahead for the next spell of growth. The definition emphasizes the dynamic relationship between resources and opportunities, requiring firms to constantly review long-term and operating strategies.

The strategic planning process involves three distinct activities, which are listed and described below:

- a. Stating vision and setting goals
- b. Identifying thrust areas, and
- c. Making strategic plan.

Goals, thrust areas and strategic plans are for a certain but a long period. The plan period may vary from three years to ten, though five year planning is more common among the Nigerian corporates. Factors like database, managerial competence and the industry situation are taken into consideration while determining the plan period.

Stating vision and setting goals

Joel Arthur Barker said

*“Vision without action is merely a dream
Action without vision just passes the time
Vision with action can change the world”.*

Nigerian firms have started defining their vision. Statements of vision among Indian firms have been expressed in many ways including, “vision 2020”, and “Enterprise 2020.”

There are two essential elements of vision statement, namely, a quantified goal and target date. John F. Kennedy articulated his vision man on the moon by the end of the decade in the year 1961. It was a dream at that time but, it galvanized into action the entire NASA programme, and Armstrong did finally set foot on the moon in July 1969. A concrete goal, and firm target date followed by a solid action plan could make a lot of difference.

For solid action, the vision has to be shared. This means that the vision must be clearly understood by everyone in the organization, accepted by all and there must be a mechanism for addressing the issues which may crop up when plans are unfolded. The last part is very important as plans executors are like to face dilemmas, conflicts and frustrations during the course of day-to-day execution.

A genuine shared vision has the following advantages:

- 1) It focuses the organization on a larger goal beyond the day-to-day target
- 2) It creates a work environment where the concept of “their company”, is replaced by “our company”
- 3) The loftiness of the vision encourages new ways of thinking and acting. It compels courage and action.

- 4) It fosters risk taking and experimentation.
- 5) It creates a spark, excitement and exhilaration in the work place.
- 6) It establishes the most basic level of commonality and ensures commitment rather than mere compliance.

There are certain thorny issues on the road of shared vision. For example: (a) the diversity of views generate unimaginable conflicts and dilemmas (b) employees get discouraged by the apparent difficulties in transforming the vision into reality, and (c) employees get overwhelmed by the demands of current reality and lose sight of vision.

Firms, whose leadership possesses the competence of managing the thorny issues involved in shared vision, are the ones which make things happen.

Defining strategic thrust areas The ways and means of attaining corporate goals stated in the vision statement must be carefully defined. This is called identification of strategic thrust areas. Strategic thrust areas must be identified after a careful analysis of the environment as well as available resources. They should also be in tune with the strategic goals.

A businessman uses various parameters in doing business. Timely delivery, good product, quality, competitive pricing distribution, packaging, credit facilities, after-sales service, effective handling of customer grievances, customer friendliness, etc. are similarly, there may be many alternative options in each functional area. An effective set of important decision variables is selected and that is called the strategic thrust area. It provides guidelines to functionaries to take decisions. It integrates all functional areas in a single thread, and eliminates the possibility of disjointed efforts.

Making strategic plans strategic thrust areas provide impetus and guidance to the exercise of designing overall and functional strategic plans. Proposals, negotiation and allocation of targets and budgets to each department are justified on the lines of strategic thrust areas. This adds objectivity to the exercise of planning and budgeting.

Master and functional strategic plans heavily draw inspiration from strategic goals and strategic thrust areas. Strategic content is vital in project management. In what direction should a firm grow? and at what rate? What type of growth strategy should be adopted? These three questions are very important in taking strategic investment decisions. The first chapter of the second section on project planning & evaluation deals with these three questions at length.

Budgeting

A long-term plan acts as a blue print for a single year's planning exercise. A limited horizon in budgeting warrants greater recognition of the short-term realities, which act as constraints. By proper allocation of resources, individual departments and the firm move towards the attainment of long-term goals. The process of resource allocation cannot be properly effected in the absence of strategic thrust areas and strategic plans. In the context of investment decisions the term 'Budgeting' means 'capital budgeting'. Capital budgeting is a process, which involves many steps starting from idea generation to evaluation of ideas and finally executing them. These steps are more fully discussed under the heading 'Capital Budgeting Decisions'.

Operating Planning

Budgeting is implemented through very short term operating plans such as machine schedules, manpower allocation schedules, etc. operating plans recognize the operating level difficulties in allocating resources, for the optimal attainment of set goals. Operating planning in the context of capital budgeting is the activity, which involves the task of preparing a detailed project report (DPR). It is a detailed blue print for the execution of the project. During the execution the project is monitored and regular reviews are conducted for mid-course re-evaluation so that corrective action can be taken.

Capital Budgeting Decisions

Capital budgeting is a part of strategic planning. It has been mentioned earlier that strategic investment decisions comprise future investment directions, rate of growth and growth strategies. This process provides an impetus for the generation of ideas. Ideas are studied and evaluated in the capital budgeting process. Many decisions are taken in this process. They are:

- 1) Cost-benefit analysis
- 2) Cut-off decision
- 3) Decision regarding the evaluation technique
- 4) Risk analysis
- 5) Capital rationing decision
- 6) Project planning, execution and monitoring
- 7) Pos-completion audit.

Many of these decisions are in turn stand-alone decisions. In a complex business firm many supportive and administrative decisions are also taken as part of the investment decisions process. How do we ensure that good investment ideas are generated? How are they to be processed? Who should process them? How are project appraisals reports to be prepared? How are capital budget to be negotiated? These and such other issues must be addressed in corporate life. Let us have a brief look at the capital budgeting decisions

Cost-Benefit Analysis

The costs and benefits associated with investment proposals are systematically studied. A study group is usually appointed to study the project proposal. This study group conducts an in-depth investigation and arrives at justifiable assumptions. A cash flow stream related to the project idea is generated on the basis of these assumptions. This involves a lot of procedural or administrative decisions by the management, in addition to well-researched policy decisions by the study group.

Cut-off Decision

How do you determine whether resulting benefits are worth the investment cost? What is a financial viability test? A cut-off rate decision (some times called a go-no-go criterion, hurdle rate or required rate of return) is very important. Should we take the cost of capital as the cut-off point? If so, then how is capital cost to be calculated? Can a cut-off be different for two different projects, which are considered at the same point of time? The answer is quite simple. An ideal cut-off rate can be calculated by adding the risk premium to the risk free rate of return. The amount of risk premium is decided on the basis of change in the risk profile of business as a result of accepting the new project. A required rate of return can be also calculated by applying the capital asset pricing model. A more pragmatic solution, however, lies in taking the risk adjusted cost of capital. The risk adjusted cost of capital is calculated by adding/subtracting the differential risk from the weighted average cost of capital.

Choice of Evaluation Technique

There are many techniques for evaluating investment proposals. Some are concerned with capital recovery, some focus on profitability, and some take the time value of cash flow into account. A company must select one or more appropriate evaluation techniques. An appropriate evaluation technique is one which may be justifiably applied to a given investment proposal. The investment evaluation criterion to be used should at least possess the following characteristics:

1. It should provide a means of distinguishing between acceptable and unacceptable projects.
2. It should provide a ranking of projects in order of their desirability
3. It should also solve the problem of choosing among alternative projects
4. It should be a criterion which is applicable to any conceivable investment project
5. It should recognize the fact that earlier benefits are preferable to later benefits.

Risk Analysis

The study of project risk and its management are two very important aspects of the capital budgeting exercise. Identification of sources of risk, measuring the risk, and including it in the decision-making process are the three issues in project risk analysis. Project risk management looks into the verification and redesigning of projects so that the risk return profile can improve. The project risk must be further analyzed

in the context of the effect of accepting a new project on the risk profile of the whole business. That means project portfolio risk analysis. A project, individually may be risky, but it may reduce the overall risk of business if accepted. Portfolio risk analysis is very vital.

Capital Rationing Decision

Can a company undertake all project proposals, which are found acceptable? Should it reject investment opportunities, which are not found acceptable? If a company cannot accept all profitable projects, then how is selection to be made? Financial priorities, strategic considerations, human considerations and statutory compulsions come in conflict with one another when a firm has limited funds. Objectively allocation of funds through a healthy process of negotiation is the real issue to be addressed in capital rationing.

Project Planning, Execution and Monitoring

This stage in corporate investment decision-making deals more with operational matters, and less with financial matters. Preparation of the DPR, its implementation and monitoring are the three major phases, DPR is the blueprint of any resource acquisition plan and is designed after considering the dual issues of resource allocation, and resource smoothing. It also gives a detailed project construction plan with time, cost and quality dimensions. A proper DPR can drastically reduce the cost of a project, by preventing cost and time escalation.

Post-Completion Audit

Project execution is completed with the preparation of the project completion report (PCR). The PCR is a report on qualitative and quantitative aspects of project planning and construction. This does not, however, complete the capital investment exercise. Has the project brought in the desired benefits, and if not, why? These questions are asked and answers sought in post completion audit (PCA). PCA is an exercise of systematic learning from mistakes. It is conducted with the objective of avoiding similar mistakes in future. It is generally conducted at the time when the project has begun setting a useful track record.

Stages in Capital Budgeting Process

Each capital budgeting proposal is unique on its own, though basic characteristics are not different. The uniqueness is in terms of initially available knowledge base and consequential risk involved. In some cases the required information is readily available because the proposers have experience in that field. Some other project proposals can be apparently attractive but due to the inadequate data support the decision-maker may not initially find his confident in taking decision. The decision-maker would like to take informed decision though reliance on intuition is not completely ruled out. A blending of the intuition and information would lead to taking a calculated risk.

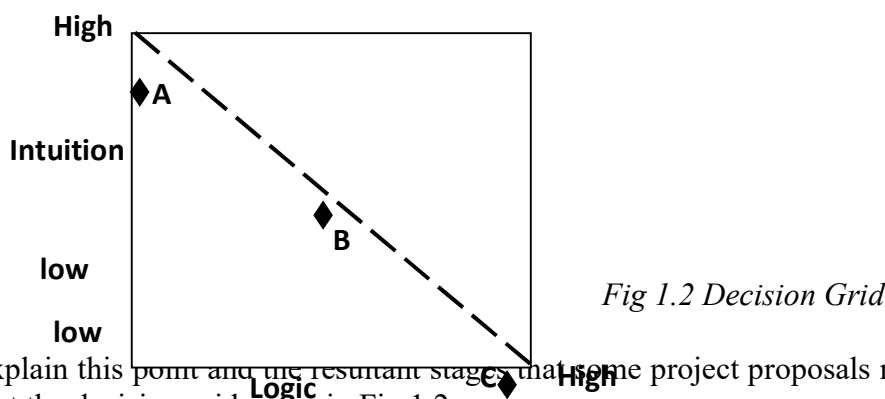


Fig 1.2 Decision Grid

To explain this point and the resultant stages that some project proposals may need to pass through let us look at the decision grid given in Fig 1.2

If we visualize the line joining points A, B and C on the Figure 1.2, the given investment proposals can be on any point on the continuum from A to C. The proposals, which are nearer the point C in figure 1.2 are likely to pass through minimum number of stages of capital budgeting process, because the information contents in such proposals are already high and therefore the risk low. The decision on these proposals can

be delegated on subordinates because they require much less intuition in taking decision, and they draw the justification from the convincing numbers. The replacement of machinery could be cited as one such project proposals, which would appear very close to the point C on the decision grid given in Figure 1.2.

A proposal for a fundamental research will be nearer the point A in the decision grid, with very low content of the existing information base. A rational decision-maker would hardly take decision when the proposed project is on nearer the point A, because it would be just an intuition-based decision and not the informed one. A rational decision-maker will initiate the process for the further study of such project proposals and gradually shift the point through the stages from nearer the point A to point B and then further down towards the point C, before taking informed decision. Some decision-makers are comfortable taking decision early on than others. Some projects, especially involving lesser investment, are also decided early on in the continuum of the line AC in the Figure 1.2. The decision-maker's perception about the risk would finally determine the point on the continuum at which the decision will be taken.

The process of shifting the position on the A-C line of the decision-grid from high intuition level (and low logic level) to moderate intuition level (and moderate logic level) would involve a few stages. The following is the list of stages in the capital budgeting process.

- 1) Conceiving idea
- 2) Initial brain-storming
- 3) Concept testing
- 4) Feasibility report
- 5) Market survey
- 6) Test marketing or pilot project plant
- 7) Project report
- 8) Market research
- 9) Detailed project report.

Individuals *conceive ideas*. The process of idea generation is stimulated and guided by the carefully carried out strategic planning process. Creative thinking is encouraged and motivated through the mechanism of strategic planning process.

The *initial brainstorming on the conceived idea* is required at the department or group level. The initial brainstorming acts as the initial feasibility check based on perceptions of many. An idea getting wider support is more likely to be commercially feasible. But, that can still be anywhere on the line A-B-C in the decision-grid given in the Figure 1.2. If it is nearer the point A, then perhaps the whole idea is very new and hardly any information are available about the pros and cons of it. The estimation of cost-benefits and associated risk may be difficult in the absence of information content. The idea has to pass through some further stages before it is considered for acceptance.

The *concept testing* could be advisable if the concept of project is new. Selling cold coffee in tetra-pack is a new concept because generally consumers consume freshly made coffee and no data is available regarding their preferences for pre-packed cold-coffee. Concept testing is a market survey aimed at testing the idea on the prospective consumer groups to judge their responses. If the results of concept testing are encouraging, the subsequent stages are considered, otherwise further expenses are saved.

A *feasibility report* will take input regarding the technical and market feasibility of the idea and work out the financial feasibility of the proposals. The technical feasibility usually gets low priority at this stage. A cursory check for available technical knowledge for the commercial exploitation of the proposals is supported with a thumb-rule-based cost of project in the feasibility report stage. The market feasibility is checked at this stage by receiving the input of demand and supply from the results of the concept testing or from the secondary sources. The focus of the market feasibility is on the evaluation of demand-supply gap and not so much on the study of marketing variables. Similarly, though the financial feasibility check is comprehensively carried out, the financing arrangements are not planned and financing instruments are not designed at these stages.

The *market survey* may be required in some cases even though feasibility report indicated the viability of the project proposals. The market survey will focus on ascertaining the expected demand for the product that the company will produce if the project proposal is accepted. It may also encompass the study of

factors, which may possibly influence the consumer behavior. The stage of market survey, thus will improve the firm's knowledge about the demand of its prospective product and the influencing factors.

Test market and a pilot project may be required in some cases, especially if the proposals are new in the concept. The respondent's responses in the concept testing stage are hardly based on experiences if the project concept is new. Therefore, even if the results of the concept testing may be encouraging, it may not provide enough confidence to go ahead with the commercial plant. A small pilot plant is set up in that case at the minimum investment; product is produced and tested on the select group of consumers and subsequently the experience-based responses are collected. The consumer response may be different after actually consuming pre-packed cold-coffee than what it was at the concept testing stage. The idea may still be carried forward only if test marketing indicated the viability of the project proposal.

A *project report* is now prepared. It takes input from the market survey of test marketing. At this stage more realistic assumptions are made for demand, sales price and other variables, technology options are further evaluated in the context of costs and resources availability. The choice of technology is made and resultant cost of the project is detailed out. Manufacturing costs are estimated for all major cost items after considering the technology choice. Working capital requirement is assessed and financing options are evaluated. The tax implications are studied and relevant cash flow is estimated, before applying financial viability check. Project report is thus, different from feasibility report in the details of information used.

A *market research* may be required in some cases after the preparation of project report. At the project report stage the focus is on the study of risk and critical success factors. The focus of market research is absolutely sharp on the selected variables identified as sources of risk. Enhanced knowledge of risk-causing variables is the obvious advantage of this stage. The results of market research fine-tune the estimates. The viability check is conducted once again on the improved data.

A *detailed project report (DPR)* is prepared much later in the stage of analysis. If the project is found viable, then first it has to be approved in principle by authority. Projects approved in principle compete for the allocation of funds. When the funds are allocated on a proposed project, the detailed project report is prepared. The DPR is a blueprint of the implementation plan. The exact resources are listed, the sources are identified, technical specifications are detailed out, costs are estimated after obtaining quotations, calendar of activities is prepared with the start and the dates, sequencing of activities is planned, period wise need of funds is estimated and so on. The DPR runs into volumes. The technical details are significant in DPR. These details must be utilized to further check the financial viability of the project.

It is not necessary that every investment proposals should go through all these stages. The initial few stages are skipped if the proposal contains the high logic and information and experience are adequate to go ahead with the project. Some of the intermediate stages can also be jumped. The information and experience provide confidence about the success of the project. The proposals that provide less confidence would pass through various stages depending upon where they start from in the decision-grid given in the Fig 1.2. The prime concern in undertaking various stages to build the data base at the minimum cost before committing sizable amount of funds in the project. If the database is available or cost of obtaining data is low then many stages can be skipped. But, highly new concept involving greater amount of money and stake will pass through many stages until the decision-makers gain confidence of taking decision.

Summary

Capital expenditure decisions must be taken with due care because they involve high stakes. These decisions are not reversible without paying a heavy cost. A long time-frame involved in capital budgeting decisions indicates the high degree of risk.

Capital expenditure decisions, therefore, must be planned in a better way so as to maximize the chances of success. This can be achieved through a logical planning process. An effective planning process would provide a solid link between the corporate objectives on one side and day-to-day actions for implementation on the other. A logical planning process typically starts with the mission and vision statement, further defined in strategic plans. Strategic plans are manifested in the budgeting exercise, followed by a series of shorter period operating plans.

Capital expenditure planning and control is part of the corporate planning process, as also many decisions taken from time to time. Strategic investment decisions, cash flow estimates, cut-off rate decision, choice of evaluation techniques, risk analysis, capital rationing decision and finally implementation of project are integral to corporate investment decisions. All these decisions must be taken with utmost care for better chance of success.

Revisionary Questions

1. What is capital expenditure? What are the elements of capital expenditure?
2. Why is capital expenditure important? Describe the important characteristics of capital expenditure.
3. What is the strategic planning process? Explain the content of strategic plans
4. Describe the care that planners must take in using a SWOT analysis for taking strategic decisions.
5. What are the stages involved in the corporate planning process? Explain them briefly
6. Define strategic planning. What are the objectives of strategic planning; and how are they attained?

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