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## SECTION - 4

### KEY DECISIONS OF FINANCIAL MANAGEMENT

**This Section include**

- **Key Decisions of Financial Management:**
- **Capital Budgeting:**
- **Capital Structure**
- **Working Capital Management**
- **Dividend:**

#### 4.1. KEY DECISIONS OF FINANCIAL MANAGEMENT

- 4.1.1 The key or major areas of financial decisions are discussed briefly in this chapter and are covered in greater detail in subsequent chapters and modules.

#### 4.2. CAPITAL BUDGETING

- 4.2.1 This is the most paramount decision any business has to take. After making the choice of business one wants to be in, an entrepreneur has to develop an investment plan to allocate the funds on various assets, such as land & buildings, plant and machinery, distribution outlets, infrastructure, brand building, research and development, technology know-how and so on. As capital is budgeted and allocated for these various assets, this decision is referred to as capital budgeting.
- 4.2.2 As capital budgeting decisions have a long term impact and can confer a long term benefit or have the potential to become a major problem and financial burden, it is important to accord sufficient time and effort in making these decisions. The choice of decision with regard to technology for manufacture of a product, location, configuration of machinery, and so on have business implications and have a major bearing on the profitability and viability of an organization. Most of the times, the decisions are irreversible. The size of the investment, the likely returns and risks associated with the project or investment and the timing of investments need to be carefully evaluated.
- 4.2.3 A careful analysis of the requirement of working capital needs and the margin money required to be earmarked also forms part of capital budgeting as margin money is long term fund.

#### 4.3. CAPITAL STRUCTURE

- 4.3.1 The next step after identifying an attractive investment opportunity and estimated the size of the investment required is working out the sources of funds also called as means of financing.



- 4.3.2 There are two major forms of capital: (1) Equity (own funds), and (2) Debt (borrowed funds). A major decision is the mix of these two types of funds, widely known as the debt-equity ratio. Decisions on various related factors such as the optimum ratio, choice of specific instruments, the capital markets the organization should access to raise the funds, the timing (see box), pricing of securities, etc. will need to be addressed.

### **Meltdown worries Wockhardt; IPO review likely**

Business Line, 23<sup>rd</sup> Jan.2008

Mumbai, Jan. 22. With nine days to go for the opening of Wockhardt Hospital's initial public offering (IPO), the management is concerned over the dramatic developments in the stock market. "We will review developments and take a call," Mr Habil Khorakiwala, Chairman of Wockhardt Hospitals Ltd told media persons, in response to queries whether the IPO would be deferred.

Steering clear of stating whether the management was looking at deferring the IPO, he reiterated that the company would take an appropriate decision when there is more clarity. Currently, the situation is fluid, he said, on a day when the market witnessed shares plummeting nearly 13 per cent during the day and trading being stopped for an hour.

## 4.4. WORKING CAPITAL MANAGEMENT

- 4.4.1 After raising funds and creating facilities that can be put to use over the long term, the next major decision is with regard to managing the day-to-day or short term operating cycle, popularly called the working capital cycle.
- 4.4.2 Working capital involves managing the current assets (inventories, debtors, marketable securities and cash) and current liabilities (short-term debt, trade creditors, and provisions).
- 4.4.3 The important decisions in relation to working capital revolve around the various components of working capital given above, such as the optimum level of inventory holding, credit granting decisions, cash management (both deficits and surplus), arranging for short-term requirements of funds, and so on.

## 4.5. DIVIDEND

- 4.5.1 Dividend decisions are again critical for an organization. The dividend payout should meet a number of criteria and expectations of different shareholders. Managing cash, providing for expansion and growth, satisfying expectations on dividend yields, creating sufficient reserves, adhering to rules governing transfer of profits to reserves etc., need to be factored in while deciding on dividends. Dividend policy needs to be evolved and followed, which will balance the requirements of the different types of investors and the requirements of the business. Some firms follow stable dividend policy-i.e paying the same rate of dividend irrespective of the profits. There are other firms which follow a variable dividend policy where the rates of dividend are varied depending on the availability of profits. Some firms do not distribute any dividend in cash but give bonus shares which has implications on the capital structure of the company. Therefore, the decision has to be taken carefully as it has long term financial implications on the company.