

The major activity of financial management is to take financial decisions viz. Capital Budgeting or Long term Investment decision (Application of funds), Capital Structure or Financing decision (Procurement of funds), Dividend decision (Distribution of funds) and Working Capital

Management Decision in order to accomplish goal of the firm viz., to maximize shareholder's (owner's) wealth.

2.1. Capital Budgeting Decision

The process of planning and managing a firm's long-term investments is called capital budgeting. In capital budgeting, the finance manager tries to identify profitable investment opportunities, i.e., assets for which value of the cash flow generated by asset exceeds the cost of that asset. Evaluating the size, timing, and risk of future cash flows (both cash inflows & outflows) is the essence of capital budgeting. A finance manager has to find answers to questions such as

- ☐ What should be the size of firm?
- ☐ At what rate should the firm grow?
- ☐ In which assets/projects funds should be invested?
- ☐ Investments in which assets/projects should be reduced or discontinued?

Capital budgeting decisions determines the fixed assets composition of a firm's Balance Sheet.

Risk-Return Trade-off: Logically, Risk \propto Return. Higher the risk, higher the return. Lower the risk, lower the return. This holds true for all investments (projects & assets). A finance manager seeks to select projects/assets which:

- (a) Minimize the risk for given level of return or
- (b) Maximize return for given degree of risk.

2.2. Capital Structure Decision

A firm's capital structure or financing decision is concerned with obtaining funds to meet firm's long term investment requirements. It refers to the specific mixture of long-term debt and equity, which the firm uses to finance its operations. It involves determining how the selected assets/projects (LHS of balance sheet) will be financed (RHS of balance sheet). What are the different sources of financing? How much funds should be raised from different sources? What should be the optimal proportion of different sources of financing in the overall financial mix or capital structure? The financial manager has to decide exactly how much funds to raise, from which sources to raise and when to raise. Different feasible combinations of raising required funds must be carefully evaluated and an optimal combination of different sources of funds should be selected.

Risk-Return Trade-off: Debt is considered cheaper than equity because interest on debt is tax deductible. Also since debt is paid before equity, risk is lower for investors and so they demand lower return on debt investments. But debt is riskier than equity as debt obligations have to be compulsorily met even if firm incurs losses. Thus there is a risk-return trade-off in deciding the optimal financing mix. On one hand, debt has lower cost of capital thus employing more debt would mean higher returns but is riskier while on the other hand, equity funds give lower return due to higher cost of capital but are less risky.

2.3. Dividend Decision

A finance manager has to decide what percentage of after tax profit is to be retained in the business to meet future investment requirements and what proportion has to be distributed as dividend among shareholders. Should the firm retain all profits or distribute all profits or retain a portion and distribute the balance? Proportion of profits distributed as dividend is called dividend pay-out ratio and the proportion of profits retained in the business is retention ratio. Finance manager here is concerned with determining the optimal dividend pay-out and retention ratio which maximizes shareholder's wealth. However, the actual decision is affected by availability of profitable investment opportunities, firm's financial needs, shareholder's expectations, legal constraints, liquidity position of the firm and other factors.

2.4. Working Capital Management Decision

Working capital management refers to management of firm's day to day financial needs. It is concerned with management of a firm's short-term or current assets, such as inventory, cash, receivables and short-term or current liabilities, such as creditors, bills payable. Assets and Liabilities which mature within the operating cycle of business or within one year are termed as current assets and current liabilities respectively. Common questions that a finance manager faces while managing working capital that must be answered are the following:

(1) What could be the possible sources of raising short term funds? (2) In what proportion should the funds be raised from different sources? (3) What should be the optimum levels of cash and inventory? (4) What should be the firm's credit policy while selling to customers?

Risk-Return Trade-off: Liquidity is inversely related to profitability, viz., $\text{Liquidity} \propto 1/\text{Profitability}$, i.e., increase in liquidity results in decrease in profitability and vice versa. Higher liquidity would mean having more of current assets. This reduces risk of default in meeting short term obligations. But current assets provide lower return than fixed assets and hence reduce profitability as funds that could earn higher return via investment in fixed assets are blocked in current assets. Thus higher liquidity would mean lower risk but also lower profits and lower liquidity would mean more risk but more returns.