

Idhaya College for Women Kumbakonam



PG & Research Department of Commerce

I M.Com

**Advanced Financial Management-
P16MC21**

Unit – I to V

**Dr. R.V. Hema,
Assistant Professor of Commerce,
Idhaya College for Women,
Kumbakonam.**



UNIT-I

Meaning of Financial Management

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

Scope / Elements:

- Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.
- Financial decisions - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.
- Dividend decision - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
 - Dividend for shareholders- Dividend and the rate of it has to be decided.
 - Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Evolution of Financial Management:

Corporation finance emerged as a distinct field of study only in the early part of this century as a result of consolidation movement and formation of large sized business undertakings. In the initial stages of the evolution of corporation finance, emphasis was placed on the study of sources and forms of financing the large sized business enterprises.



The grave economic recession of 1930's rendered difficulties in raising finance from banks and other financial institutions. Thus, emphasis was laid upon improved methods of planning and control, sound financial structure of the firm and more concern for liquidity. The ways and means of evaluating the credit worthiness of firms were developed.

The post-World War II era necessitated reorganisation of industries and the need for selecting sound financial structure. In the early 50's the emphasis shifted from the profitability to liquidity and from institutional finance to day to day operations of the firm. The techniques of analysing capital investment in the form of 'capital budgeting' were also developed. Thus, the scope of financial management widened to include the process of decision-making within the firm.

The modern phase began in mid-fifties and the discipline of corporation finance or financial management has now become more analytical and quantitative. 1960's witnessed phenomenal advances in the theory of 'portfolio analysis' by Microwitz, Sharpe, Lintner etc. Capital Asset Pricing Model (CAPM) was developed in 1970's.

The CAPM suggested that some of the risks in investments can be neutralised by holding of diversified portfolio of securities. The 'Option Pricing Theory' was also developed in the form of the Binomial Model and the Black-Scholes Model during this period. The role of taxation in personal and corporate finance was emphasised in 80's.

Further, newer avenues of raising finance with the introduction of new capital market instruments such as PCD's, FCD's, PSB's and CPP's etc. were also introduced. Globalisation of markets has witnessed the emergence of 'Financial Engineering' which involves the design, development and implementation of innovative financial instruments and the formulation of creative optimal solutions to problems in finance.

The techniques of models, mathematical programming and simulations are presently being used in corporation finance and it has achieved the prime place of importance. We may conclude that financial management has evolved from a branch of economics to a distinct subject of detailed study of its own.



Objectives of Financial Management

Effective procurement and efficient use of finance lead to proper utilization of the finance by the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management. Objectives of Financial Management may be broadly divided into two parts such as:

1. Profit maximization
2. Wealth maximization.

Importance of Financial Management

Finance is the lifeblood of business organization. It needs to meet the requirement of the business concern. Each and every business concern must maintain adequate amount of finance for their smooth running of the business concern and also maintain the business carefully to achieve the goal of the business concern. The business goal can be achieved only with the help of effective management of finance. We can't neglect the importance of finance at any time at and at any situation. Some of the importance of the financial management is as follows:

- **Financial Planning:** Financial management helps to determine the financial requirement of the business concern and leads to take financial planning of the concern. Financial planning is an important part of the business concern, which helps to promotion of an enterprise.
- **Acquisition of Funds:** Financial management involves the acquisition of required finance to the business concern. Acquiring needed funds play a major part of the financial management, which involve possible source of finance at minimum cost.
- **Proper Use of Funds:** Proper use and allocation of funds leads to improve the operational efficiency of the business concern. When the finance manager uses

the funds properly, they can reduce the cost of capital and increase the value of the firm.

- **Financial Decision:** Financial management helps to take sound financial decision in the business concern. Financial decision will affect the entire business operation of the concern. Because there is a direct relationship with various department functions such as marketing, production personnel, etc.
- **Improve Profitability:** Profitability of the concern purely depends on the effectiveness and proper utilization of funds by the business concern. Financial management helps to improve the profitability position of the concern with the help of strong financial control devices such as budgetary control, ratio analysis and cost volume profit analysis.
- **Increase the Value of the Firm:** Financial management is very important in the field of increasing the wealth of the investors and the business concern. Ultimate aim of any business concern will achieve the maximum profit and higher profitability leads to maximize the wealth of the investors as well as the nation.
- **Promoting Savings:** Savings are possible only when the business concern earns higher profitability and maximizing wealth. Effective financial management helps to promoting and mobilizing individual and corporate savings.

Nowadays financial management is also popularly known as business finance or corporate finances. The business concern or corporate sectors cannot function without the importance of the financial management.

Financial Planning

Smooth and successful running of a company requires steady supply of its financial requirements. The long term and short term requirements of finance are to be met in time. Financial management looks into the future and arranges for provision of adequate finance in time.

Objectives of financial planning



Financial Planning has got many objectives to look forward to:

1. **Determining capital requirements-** This will depend upon factors like cost of current and fixed assets, promotional expenses and long- range planning. Capital requirements have to be looked with both aspects: short- term and long- term requirements.
2. **Determining capital structure-** The capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business
3. **Framing financial policies** with regards to cash control, lending, borrowings, etc.
4. A finance manager **ensures that the scarce financial resources are maximally utilized in the best possible manner** at least cost in order to get maximum returns on investment.

UNIT-II

Time Value of Money

Understanding the time value of money is crucial to effective financial management. In fact, anyone who is involved with money should have some comprehension of the time value of money. Consider the following:

- A banker who makes loans and other investments
- A financial officer whose job includes the consideration of various alternative sources of funds in terms of their cost
- A company manager who must choose among various alternative investment projects
- A securities analyst who evaluates the securities that a firm sells to investors
- An individual who is confronted with a host of daily financial problems ranging from personal credit account management to deciding how to finance a new home purchase



- Each of these individuals makes frequent use of the time value of money. Many people fear that a working knowledge of the time value of money concept might be too difficult to master. However, the availability of interest tables, financial calculators, and spreadsheet programs such as Excel makes the subject readily accessible.

Although an understanding of the time value of money is useful in and of itself, it is also a necessary prelude to the following topics:

- Valuation of securities and other assets
- Capital budgeting (the analysis of investment projects)
- The cost of capital
- Working capital (short-term asset and liability) management
- Lease analysis

Present value calculations

One common time-value problem deals with expecting a specified sum of money at a point in the future. Because money earned in the future is worth less than money earned now, you have to apply a discount to the future payment in order to get its equivalent present value. Often, the discount rate used is equal to the prevailing risk-free rate for assets like Treasury securities without default risk. The further into the future the payment is, the greater the discount.

The math behind a present value calculation is a bit complicated but can be done with a basic calculator. To come up with present value, take 1 and add it to the discount rate used. Then raise that number to the power of the number of years in the future that you'll receive the payment. Save the resulting figure, and then divide the future payment amount by that figure. The final result will be the present value.

For instance, say you know that you'll receive \$110.25 in two years and decide that a discount rate of 5% is appropriate. In that case, 1 plus 5% equals 1.05, and 1.05 raised to the second power is 1.1025. Divide \$110.25 by 1.1025, and you get \$100,



which is the present value.

Techniques of Time Value of Money

Future value calculations work in the opposite manner. You'll follow the same steps as you did for present value, adding 1 to the discount rate and then raising that number to the power of the number of years in the future that you're measuring the future value. But then, you'll need to multiply the result by the value of the current payment. The final result is the future value.

For instance, if you want to know the future value of \$100 in two years assuming a rate of 5%, then $1 + 5\%$ is 1.05, 1.05 raised to the second power is 1.1025, and \$100 multiplied by 1.1025 is \$110.25. As you can see, this matches up with the present value calculation above.

Recurring value techniques

The two methods discussed above work well for one-time payments, but other methods are better for recurring payments. You can always just calculate present or future value for each payment separately, but there are sometimes shortcuts available for common situations.

For instance, say you have an asset that pays a perpetual stream of income. You can't calculate each payment separately, but the equation for its present value turns out to be quite simple: take the amount of each regular payment and divide it by the discount rate. So if you receive \$100 each year and use a discount rate of 5%, then its present value is $\$100 / 5\% = \$2,000$.

Valuation of Securities

Security valuation is important to decide on the portfolio of an investor. All investment decisions are to be made on a scientific analysis of the right price of a share. Hence, an understanding of the valuation of securities is essential. Investors should buy underpriced shares and sell overpriced shares. Share pricing is thus an important aspect of trading. Conceptually, four types of valuation models are discernible.



They are

- (i). Book value,
- (ii) Liquidating value,
- (iii) Intrinsic value,
- (iv) Replacement value as compared to market price.

i) Book Value:

Book value of a security is an accounting concept. The book value of an equity share is equal to the net worth of the firm divided by the number of equity shares, where the net worth is equal to equity capital plus free reserves. The market value may fluctuate around the book value but may be higher if the future prospects are good.

(ii) Liquidating Value (Breakdown Value):

If the assets are valued at their breakdown value in the market and take net fixed assets plus current assets minus current liabilities as if the company is liquidated, then divide this by the number of shares, the resultant value is the liquidating value per share. This is also an accounting concept.

(iii) Intrinsic Value:

Market value of a security is the price at which the security is traded in the market and it is generally hovering around its intrinsic value. There are different schools of thought regarding the relationship of intrinsic value to the market price. Market prices are those which rule in the market, resulting from the demand and supply forces. Intrinsic price is the true value of the share, which depends on its earning capacity and its true worth. According to the fundamentalist approach to security valuation, the value of the security must be equal to the discounted value of the future income stream. The investor buys the securities when the market price is below this value.

Thus, for fundamentalists, earnings and dividends are the essential ingredients in determining the market value of a security. The discount rate used in such present value

calculations is known as the required rate or return. Using this discount rate all future earnings are discounted back to the present to determine the intrinsic value.

According to the technical school, the price of a security is determined by the market demand and supply and it has very little to do with intrinsic values. The price movements follow certain trends for varying periods of time. Changes in trend represent the shifts in demand and supply which are predictable. The present trends are the offshoot of the past and history repeats itself according to this school.

According to efficient market hypothesis, in a fairly large security market where competitive conditions prevail, market prices are good proxies for intrinsic values. The security prices are determined after absorbing all the information available to market participants. A share is thus generally worth whatever it is selling for in the market.

Generally, fundamental school is the basis for security valuation and many models are in use, based on these tenets.

(iv) Replacement Value:

When the company is liquidated and its assets are to be replaced by new ones, their prices being higher, the replacement value of a share will be different from the Breakdown value. Some analysts take this replacement value to compare with the market price.

Factors Influencing Security Valuation

Security price depends on a host of factors like earnings per share, prospects of expansion, future earnings potential, possible issue of bonus or rights shares, etc. Some demand for a particular stock may give pleasure of power as a shareholder or prestige and control on management. Satisfaction and pleasure in the non-monetary sense cannot be considered in any practical and quantifiable sense. Many psychological and emotional factors influence the demand for a share.

In money terms, the return to a security on which its value depends consists of two components:

(i) Regular dividends or interest, and

(ii) Capital gains or losses in the form of changes in the capital value of the asset.

If the risk is high, return should also be high. Risk here refers to uncertainty of receipt of principal and interest or dividend and variability of this return.

UNIT-III

Cost of Capital

The cost of capital of a firm is the minimum rate of return expected by its investors. It is the weighted average cost of various sources of finance used by a firm. The capital used by a firm may be in the form of debt, preference capital, retained earnings and equity shares. The concept of cost of capital is very important in the financial management. A decision to invest in a particular project depends upon the cost of capital of the firm or the cut off rate which is the minimum rate of return expected by the investors.

Definition

James C. Van Horne defines cost of capital as, "a cut-off rate for the allocation of capital to investments of projects. It is the rate of return on a project that will leave unchanged the market price of the stock.

According to Solomon Ezra, "Cost of capital is the minimum required rate of earning or the cut-off rate of capital expenditures".

Computation of Weighted Average Cost of Capital

Weighted average cost of capital is the average cost of the costs of various sources of Financing. Weighted average cost of capital is also known as composite cost of capital, overall cost of capital or average cost of capital. Once the specific cost of individual sources of finance is determined, we can compute the weighted average cost of capital by putting weights to the specific costs of capital in proportion of the



various sources of funds to the total. The weights may be given either by using the book value of the source or market value of the source. The market value weights suffer from the following limitations: It is very difficult to determine the market values because of frequent fluctuations. With the use of market value weights, equity capital gets greater importance.

Measurement of Cost of Capital

The term cost of capital is an overall cost. This is the combination cost of the specific cost associated with specific source of financing. The computation of cost capital therefore, involves two steps: The computation of the different elements of the cost in term of the cost of the different source of finance. The calculation of the overall cost by combining the specific cost into a composite cost.

From the view point of capital budgeting decisions the long-term sources of fund are relevant as the constitute the major source of financing of fixed cost. In calculating the cost of capital, therefore, the focus is to be on the long-term funds. In other words the specific cost has to be calculated for: 1) Long term debt 2) Preference Shares 3) Equity Shares 4) Retained earnings

Cost of Preference Capital

A fixed rate of dividend is payable on preference shares. Though dividend is payable at the discretion of the Board of directors and there is no legal binding to pay dividend, yet it does not mean that preference capital is cost free. The cost of preference capital is a function of dividend expected by its investors, i.e., its stated dividend. In case dividend share not paid to preference shareholders, it will affect the fund raising capacity of the firm. Hence, dividends are usually paid regularly of preference shares expect when there are no profits to pay dividends.

Cost of Equity Share Capital

The cost of equity is the maximum rate of return that the company must earn of equity financed portion of its investments in order to leave unchanged the market price of its stock". The cost of equity capital is a function of the expected return by its

investors. The cost of equity is not the out-of-pocket cost of using equity capital as the equity shareholders are not paid dividend at a fixed rate every year. Moreover, payment of dividend is not a legal binding. It may or may not be paid. But it does not mean that equity share capital is a cost free capital. Share holders invest money in equity shares on the expectation of getting dividend and the company must earn this minimum rate so that the market price of the shares remains unchanged. Whenever a company wants to raise additional funds by the issue of new equity shares, the expectations of the shareholders have to evaluate.

LEVERAGE

Meaning of Leverage

The word 'leverage', borrowed from physics, is frequently used in financial management. The object of application of which is made to gain higher financial benefits compared to the fixed charges payable, as it happens in physics i.e., gaining larger benefits by using lesser amount of force.

Definition of Leverage

According to J. C. Van Horne "Leverage is the employment of an asset or funds for which the firm pays a fixed cost of fixed return."

Types of Leverage

Leverage are three types:

- (i) Operating leverage
- (ii) Financial leverage and
- (iii) Combined leverage

1. Operating Leverage:

Operating leverage refers to the use of fixed operating costs such as depreciation, insurance of assets, repairs and maintenance, property taxes etc. in the

operations of a firm. But it does not include interest on debt capital. Higher the proportion of fixed operating cost as compared to variable cost, higher is the operating leverage, and vice versa.

Operating leverage may be defined as the “firm’s ability to use fixed operating cost to magnify effects of changes in sales on its earnings before interest and taxes.”

In practice, a firm will have three types of cost viz:

(i) Variable cost that tends to vary in direct proportion to the change in the volume of activity,

(ii) Fixed costs which tend to remain fixed irrespective of variations in the volume of activity within a relevant range and during a defined period of time,

(iii) Semi-variable or Semi-fixed costs which are partly fixed and partly variable. They can be segregated into variable and fixed elements and included in the respective group of costs.

Operating leverage occurs when a firm incurs fixed costs which are to be recovered out of sales revenue irrespective of the volume of business in a period. In a firm having fixed costs in the total cost structure, a given change in sales will result in a disproportionate change in the operating profit or EBIT of the firm.

If there is no fixed cost in the total cost structure, then the firm will not have an operating leverage. In that case, the operating profit or EBIT varies in direct proportion to the changes in sales volume.

Operating leverage is associated with operating risk or business risk. The higher the fixed operating costs, the higher the firm’s operating leverage and its operating risk. Operating risk is the degree of uncertainty that the firm has faced in meeting its fixed operating cost where there is variability of EBIT.

It arises when there is volatility in earnings of a firm due to changes in demand, supply, economic environment, business conditions etc. The larger the magnitude of operating leverage, the larger is the volume of sales required to cover all fixed costs.

Financial Leverage

Financial leverage is primarily concerned with the financial activities which involve raising of funds from the sources for which a firm has to bear fixed charges such as interest expenses, loan fees etc. These sources include long-term debt (i.e., debentures, bonds etc.) and preference share capital.

Long term debt capital carries a contractual fixed rate of interest and its payment is obligatory irrespective of the fact whether the firm earns a profit or not.

As debt providers have prior claim on income and assets of a firm over equity shareholders, their rate of interest is generally lower than the expected return in equity shareholders. Further, interest on debt capital is a tax deductible expense.

These two facts lead to the magnification of the rate of return on equity share capital and hence earnings per share. Thus, the effect of changes in operating profits or EBIT on the earnings per share is shown by the financial leverage.

According to Gitman financial leverage is “the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on firm’s earnings per share”. In other words, financial leverage involves the use of funds obtained at a fixed cost in the hope of increasing the return to the equity shareholders.

Favourable or positive financial leverage occurs when a firm earns more on the assets/ investment purchased with the funds, than the fixed cost of their use. Unfavorable or negative leverage occurs when the firm does not earn as much as the funds cost.

Thus shareholders gain where the firm earns a higher rate of return and pays a lower rate of return to the supplier of long-term funds. The difference between the earnings from the assets and the fixed cost on the use of funds goes to the equity shareholders. Financial leverage is also, therefore, called as ‘trading on equity’.

Financial leverage is associated with financial risk. Financial risk refers to risk of the firm not being able to cover its fixed financial costs due to variation in EBIT. With the

increase in financial charges, the firm is also required to raise the level of EBIT necessary to meet financial charges. If the firm cannot cover these financial payments it can be technically forced into liquidation.

Combined Leverage

Operating leverage shows the operating risk and is measured by the percentage change in EBIT due to percentage change in sales. The financial leverage shows the financial risk and is measured by the percentage change in EPS due to percentage change in EBIT.

Both operating and financial leverages are closely concerned with ascertaining the firm's ability to cover fixed costs or fixed rate of interest obligation, if we combine them, the result is total leverage and the risk associated with combined leverage is known as total risk. It measures the effect of a percentage change in sales on percentage change in EPS.

UNIT-IV

Capital Structure

Capital structure refers to the kinds of securities and the proportionate amounts that make up capitalization. It is the mix of different sources of long-term sources such as equity shares, preference shares, debentures, long-term loans and retained earnings. The term capital structure refers to the relationship between the various long-term sources financing such as equity capital, preference share capital and debt capital. Deciding the suitable capital structure is the important decision of the financial management because it is closely related to the value of the firm. Capital structure is the permanent financing of the company represented primarily by long-term debt and equity.

Definition of Capital Structure

According to the definition of Gerestenbeg, "Capital Structure of a company



refers to the composition or make up of its capitalization and it includes all long-term capital resources". According to the definition of James C. Van Horne, "The mix of a firm's permanent long-term financing represented by debt, preferred stock, and common stock equity". According to the definition of Persona Chandra, "The composition of a firm's financing consists of equity, preference, and debt.

Financial Structure

The term financial structure is different from the capital structure. Financial structure shows the pattern total financing. It measures the extent to which total funds are available to finance the total assets of the business. $\text{Financial Structure} = \text{Total liabilities}$

Optimum Capital Structure

Optimum capital structure is the capital structure at which the weighted average cost of capital is minimum and thereby the value of the firm is maximum. Optimum capital structure may be defined as the capital structure or combination of debt and equity that leads to the maximum value of the firm.

Factors Determining Capital Structure

The following factors are considered while deciding the capital structure of the firm. Leverage It is the basic and important factor, which affect the capital structure. It uses the fixed cost financing such as debt, equity and preference share capital. It is closely related to the overall cost of capital. Cost of Capital Cost of capital constitutes the major part for deciding the capital structure of a firm. Normally long- term finance such as equity and debt consist of fixed cost while mobilization. When the cost of capital increases, value of the firm will also decrease. Hence the firm must take careful steps to reduce the cost of capital.

(a) **Nature of the business:** Use of fixed interest/dividend bearing finance depends upon the nature of the business. If the business consists of long period of operation, it will apply for equity than debt, and it will reduce the cost of capital.



(b) Size of the company: It also affects the capital structure of a firm. If the firm belongs to large scale, it can manage the financial requirements with the help of internal sources. But if it is small size, they will go for external finance. It consists of high cost of capital. (

c) Legal requirements: Legal requirements are also one of the considerations while dividing the capital structure of a firm. For example, banking companies are restricted to raise funds from some sources.

(d) Requirement of investors: In order to collect funds from different type of investors, it will be appropriate for the companies to issue different sources of securities. Government policy Promoter contribution is fixed by the company Act. It restricts to mobilize large, longterm funds from external sources. Hence the company must consider government policy regarding the capital structure.

Capital Structure Theories

Capital structure is the major part of the firm's financial decision which affects the value of the firm and it leads to change EBIT and market value of the shares. There is a relationship among the capital structure, cost of capital and value of the firm. The aim of effective capital structure is to maximize the value of the firm and to reduce the cost of capital.

There are two major theories explaining the relationship between capital structure, cost of capital and value of the firm.

Traditional Approach It is the mix of Net Income approach and Net Operating Income approach. Hence, it is also called as intermediate approach. According to the traditional approach, mix of debt and equity capital can increase the value of the firm by reducing overall cost of capital up to certain level of debt. Traditional approach states that the K_o decreases only within the responsible limit of financial leverage and when reaching the minimum level, it starts increasing with financial leverage.

Assumptions: Capital structure theories are based on certain assumption to analysis in a single and convenient manner:

- There are only two sources of funds used by a firm; debt and shares.
- The firm pays 100% of its earning as dividend.
- The total assets are given and do not change.
- The total finance remains constant.
- The operating profits (EBIT) are not expected to grow.
- The business risk remains constant.
- The firm has a perpetual life.
- The investors behave rationally

Net Income (NI) Approach :

Net income approach suggested by the Durand. According to this approach, the capital structure decision is relevant to the valuation of the firm. In other words, a change in the capital structure leads to a corresponding change in the overall cost of capital as well as the total value of the firm. According to this approach, use more debt finance to reduce the overall cost of capital and increase the value of firm. Net income approach is based on the following three important assumptions: 1. There are no corporate taxes. 2. The cost debt is less than the cost of equity. 3. The use of debt does not change the risk perception of the investor.

Net Operating Income (NOI) Approach:

Another modern theory of capital structure, suggested by Durand. This is just the opposite to the Net Income approach. According to this approach, Capital Structure decision is irrelevant to the valuation of the firm. The market value of the firm is not at all affected by the capital structure changes. According to this approach, the change in capital structure will not lead to any change in the total value of the firm and market price of shares as well as the overall cost of capital. 56 Financial Management NI approach is based on the following important assumptions; The overall cost of capital remains constant; There are no corporate taxes; The market capitalizes the value of the

firm as a whole;

Modigliani and Miller Approach:

Modigliani and Miller approach states that the financing decision of a firm does not affect the market value of a firm in a perfect capital market. In other words MM approach maintains that the average cost of capital does not change with change in the debt weighted equity mix or capital structures of the firm. Modigliani and Miller approach is based on the following important assumptions: • There is a perfect capital market. • There are no retained earnings. • There are no corporate taxes. • The investors act rationally. • The dividend payout ratio is 100%. • The business consists of the same level of business risk.

Meaning of Dividend

Dividend refers to the business concerns net profits distributed among the shareholders. It may also be termed as the part of the profit of a business concern, which is distributed among its shareholders. According to the Institute of Chartered Accountant of India, dividend is defined as “a distribution to shareholders out of profits or reserves available for this purpose”.

Types of Dividend/Form of Dividend

(a) Cash dividend

A cash dividend is a usual method of paying dividends. Payment of dividend in cash results in the reduction out flow of funds and reduces the net worth of the company. The share holders get an opportunity to invest the cash in any manner, they desire. Hence, the ordinary share holders prefer to receive dividends in cash. In case of companies having cash dividends, the firm must have adequate liquid resources, so that its liquidity position is not adversely affected on account of cash dividend.

(b) Scrip (or) Bond dividend

A scrip dividend promises to pay the share holders at a future specific date. In case a company does not have sufficient funds to pay dividends in cash, it may issue

notes or bonds for amounts due to the share holders. The objective of scrip dividends is to postpone the immediate payment of cash. A scrip dividend bears interest and is accepted as collateral security.

(c) Property Dividend

Property dividends are paid in the form of some assets other than cash. They are distributed under exceptional circumstances and are not popular in India.

(d) Stock Dividend

Stocks dividend means the issue and the bonus shares to the existing share holders. If a company does not have liquid resources, it is better to declare stock dividends. Stock dividend amounts to capitalization of earnings and distribution of profits among the existing share holders without affecting the cash position of the firm.

Bonus Share

A company can pay bonus to its share holders either in cash or in the form of shares. Many a times a company need not in a position to pay bonus in cash, in spite of sufficient profits, because of unsatisfactory cash position or because of its adverse effects on the working capital of the company.

Factors Determining Dividend Policy

1. Profitable Position of the Firm

Dividend decision depends on the profitable position of the business concern. When the firm earns more profit, they can distribute more dividends to the shareholders.

2. Uncertainty of Future

Income Future income is a very important factor, which affects the dividend policy. When the shareholder needs regular income, the firm should maintain regular dividend policy.

3. Contractual constraints

Often, the firm's ability to pay cash dividends is constrained by restrictive provisions in a loan agreement. Generally, these constraints prohibit the payment of cash dividends until a certain level of earnings have been achieved, or they may limit dividends to a certain amount or a percentage of earnings. Constraints on dividends help to protect creditors from losses due to the firm's insolvency. The violation of a contractual constraint is generally grounds for a demand of immediate payment by the funds supplier.

4. Internal constraints

The firm's ability to pay cash dividends is generally constrained by the amount of excess cash available rather than the level of retained earnings against which to charge them. Although it is possible for a firm to borrow funds to pay dividends, lenders are generally reluctant to make such loans because they produce no tangible or operating benefits that will help the firm repay the loan. Although the firm may have high earnings, its ability to pay dividends may be constrained by a low level of liquid assets. (Cash and marketable securities) We will take the previous example to explain this point. In our example, the firm can pay Rs.1, 40,000 in dividends. Suppose that the firm has total liquid assets of Rs.50, 000 (Rs.20, 000 cash +marketable securities worth Rs.30, 000) and Rs.35, 000 of this is needed for operations, the maximum cash dividend the firm can pay is 15,000 (Rs.50, 000 – Rs.35, 000)

5. Growth prospects

The firm's financial requirements are directly related to the anticipated degree of asset expansion. If the firm is in a growth stage, it may need all its funds to finance capital expenditures. Firms exhibiting little or no growth may never need replace or renew assets. A growth firm is likely to have to depend heavily on internal financing through retained earnings instead of distributing current income as dividends.

6. Owner considerations

In establishing a dividend policy, the firm's primary concern normally would be to maximize shareholder's wealth. One such consideration is then tax status of a firm's



owners. Suppose that if a firm has a large percentage of wealthy shareholders who are in a high tax bracket, it may decide to pay out a lower percentage of its earnings to allow the owners to delay the payments of taxes until they sell the stock. Of course, when the equity share is sold, the proceeds are in excess of the original purchase price, the capital gain will be taxed, possible at a more favorable rate than the one applied to ordinary income. Lower-income shareholders, however who need dividend income will prefer a higher payout of earnings. As of now, the dividend income is not taxed in the hands of the share holders in India. Instead, for paying out such dividends to its share holders, the company bears the dividend distribution tax.

7. Market Considerations

The risk-return concept also applies to the firm's dividend policy. A firm where the dividends fluctuate from period to period will be viewed as risky, and investors will require a high rate of return, which will increase the firm's cost of capital. So, the firm's dividend policy also depends on the market's probable response to certain types of policies. Shareholders are believed to value a fixed or increasing level of dividends as opposed to a fluctuating pattern of dividends.

8. Legal Constraints

The Companies Act 1956 has put several restrictions regarding payments and declaration of dividends. Similarly, Income Tax Act, 1961 also lays down certain restrictions on payment of dividends.

9. Liquidity Position

Liquidity position of the firms leads to easy payments of dividend. If the firms have high liquidity, the firms can provide cash dividend otherwise, they have to pay stock dividend.

10. Sources of Finance

If the firm has finance sources, it will be easy to mobilize large finance. The firm shall not go for retained earnings.



11. Growth Rate of the Firm

High growth rate implies that the firm can distribute more dividends to its shareholders.

12. Tax Policy

Tax policy of the government also affects the dividend policy of the firm. When the government gives tax incentives, the company pays more dividends.

Types of Dividend Policy

Dividend policy depends upon the nature of the firm, type of shareholder and profitable position. On the basis of the dividend declaration by the firm, the dividend policy may be classified under the following types:

- Regular dividend policy
- Stable dividend policy
- Irregular dividend policy
- No dividend policy.

Regular Dividend Policy

Dividend payable at the usual rate is called as regular dividend policy. This type of policy is suitable to the small investors, retired persons and others. Stable Dividend Policy Stable dividend policy means payment of certain minimum amount of dividend regularly.

This dividend policy consists of the following three important forms: Constant dividend per share Constant payout ratio Stable rupee dividend plus extra dividend.

Irregular Dividend Policy

When the companies are facing constraints of earnings and unsuccessful business operation, they may follow irregular dividend policy. It is one of the temporary

arrangements to meet the financial problems. These types are having adequate profit. For others no dividend is distributed.

No Dividend Policy

Sometimes the company may follow no dividend policy because of its unfavorable working capital position of the amount required for future growth of the concerns.

UNIT-V

Definition

In the words of Shubin, "Working capital is the amount of funds necessary to cover the cost of operating the enterprise".

According to Genestenberg, "Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, as for example, from cash to inventories, inventories to receivables, receivables into cash".

Concepts of Working Capital

There are two concepts of working capital: (A)Balance Sheet Concept (B) Operating Cycle or Circular Flow Concept (A)Balance Sheet Concept: There are two interpretations of working capital under the balance sheet concept: (i) Gross Working Capital (ii) Net Working capital In the broad sense, the term working capital refers to the gross working capital and represents the amount of funds invested in current assets. Thus, the gross working capital is the capital invested in total current assets of the enterprise; current assets are those assets which in the ordinary course of business can be converted into cash within a short period of normally one accounting year.

In a narrow sense, the term working capital refers to the new working capital. Net working capital is the excess of current assets over current liabilities or say:

Net Working Capital = Current Assets – Current Liabilities. Net Working Capital

may be positive or negative. When the current assets exceed the current liabilities the working capital is positive and the negative working capital results when the current liabilities are more than the current assets. Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year out of the current assets or the income of the business.

Operating Cycle or Circular Flow Concept As discussed earlier, working capital refers to that part of firm's capital which is required for financing short-term or current assets such as cash, marketable securities, debtors and inventories. Funds, thus, invested in current assets such as cash, marketable securities, debtors and inventories. Funds, thus, invested again in exchange for other current assets.

The gross operating cycle of a firm is equal to the length of the inventories and receivables conversion periods.

$$\text{Gross Operating Cycle} = \text{RMCP} + \text{WIPCP} + \text{RCP}$$

Thus, Where, RMCP = Raw Material Conversion Period WIPCP = Work-in-Process Conversion Period FGCP = Finished Goods Conversion Period RCP = Receivables Conversion Period.

Characteristics of Working Capital

1. Short –term Requirements

Working capital is utilized to purchase current assets which can be easily converted into cash in short period of time. The length of production process decides the duration of working capital; it is the time period between sale and cash receipts.

2. Circular Movement

Working capital is continuously transformed into cash but it again turns into working capital. This process is on continuous basis. When cash is utilized to purchase current assets and with the help of current assets goods are produced and sold then therefore working capital is also termed as circulating capital.



3. Permanence

Working capital is a short-term capital but in order to continue the production process it is always required by the firm. Hence working capital is also termed as permanence or regular working capital.

4. Instability

Though working capital is required permanently in a firm but the amount of working capital required frequently changes with the changes in production level, changes in purchase, sale policy, price level and demand level. The amount of working capital that changes due to changes in other factors is called variable working capital.

5. Liquidity

Working capital can be easily converted into cash, hence it is more liquid. Firms which maintain adequate amount of working capital finds easy to convert it into cash in time when cash is required.

6. Less Risky

Working capital is the investment in current assets which is for a short period of time. Hence it involves less risk. Working capital does not involve any risk related to technological changes. It involves a very less amount of physical risk only.

7. Special Accounting System not Required

As working capital is for short-term usually for one year. Hence, there is no need to adopt special accounting system for it.

Forecast/Estimate of Working Capital Requirements

“Working capital is the life-blood and controlling nerve centre of a business”. No business can be successfully run without an adequate amount of working capital. To avoid the shortage of working capital at once, an estimate of working capital requirements should be made in advance so that arrangements can be made to procure adequate working capital. Methods of Estimating Working Capital Requirements The

following method are usually followed in forecasting working capital requirements of a firm 1. Percentage of Sales Method 2. Regression Analysis Method 3. Cash Forecasting Method 4. Operating Cycle Method 5. Projected Balance Sheet Method.

Working Capital Policy

Working capital policy can also be known as working capital management. Working capital management refers to a strategy which mainly focus on maintaining adequate level of current assets and current liabilities in a firm, so that appropriate level of working capital can be maintained.

The ratio helps to examine the following alternative working capital policies:

1. Conservative Policies

Assuming a constant level of fixed assets, a higher current assets to fixed assets ratio, refers to conservative policies. It indicates the firm's sound liquidity position and lower risk to meet its current obligations and investments. This policy is also termed as flexible policy. It also indicates that the current assets are efficiently utilized at every levels or output. Conservative Policy Indicates (i) Sound liquidity (ii) Lower risk (iii) Current assets are efficiently utilized in production (iv) No bottlenecks in production, because of the maintenance of huge stock (v) Prompt payment of accounts payable, because of huge liquid cash in hand.

2. Moderate Policies

Moderate policy is otherwise termed as average current assets policy. This ratio occurs between higher and lower ratio of current assets to fixed assets ratio. In other words, the current assets policy of most firms may fall between the conservative policies and aggressive policies. This indicates moderate risk and average liquidity position of a firm. Moderate Policy Indicates: (i) Moderate risk (ii) Average liquidity position (iii) Current assets are used in production (iv) Maintenance of stock of raw materials, work-in-progress and finished goods are at an average level. 3. Aggressive Policies: Lower level of current assets to fixed assets ratio represents aggressive policy. This aggressive policy indicates higher risk and poor liquidity position of a firm. It also

indicates that the current assets are inefficiently utilized at all levels of output. This policy is also termed as restrictive policy. Aggressive Policy Indicates (i) Poor liquidity position (ii) Higher risk (iii) Current assets are utilized at lowest in all levels of output (iv) Maintenance of small stock levels (v) Declining size of sales because of rare credit sales facilities (vi) Stoppage and bottlenecks in production, due to lack of stock (vii) Slower accounts payable payments, because of low cash balance in hand.

