E- CONTENT MATERIAL

S.T.E.T WOMEN'S COLLEGE MANNARGUDI
PG AND RESEARCH DEPARTMENT OF COMMERCE

SUBJECT: Advanced Financial Management
SUBJECT CODE: P16MC21

CLASS: II M.COM

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CAPITAL STRUCTURE

Introduction

Capital structure decision is a significant decision in financial management. This decision in a private enterprise is directed towards the achievement of maximization of the shareholders' wealth or value of the firm. The value of an enterprise depends on expected earnings and cost of capital. Capital structure influences the value of the firm by operating on either expected earnings or the cost of capital or both. Due to tax deductibility of interest payments, recourse to debt financing generally reduces the firm's tax liability, but increases the financial risk.

MEANING OF CAPITAL STRUCTURE

Capital structure is the permanent financing of the company represented primarily by long- term debt and shareholder's funds but excluding all short-term credit. The term capital structure differs from financial structure. Financial structure refers to the way the firm's assets are financed. In other words, it includes both, long-term as well as short-term sourced of funds. Thus a company's capital structure is only a part of its financial structure.

FACTORS AFFECTING CAP[ITAL STRUCTURE

- The nature of the business
- Regularity of earnings
- Conditions of the money market
- Attitude of the investor
- Debt-equity mix

Capital Structure Theories

Net Income and Approaches

Net Income and Approach were developed by David Durand.1 The essence of net income approach is that the firm can lower its cost of capital by using debt. The approach is based on the assumption that the use of debt does not change the risk perception of the investor. Consequently the interest rate on debt (Ki) and the equity capitalization rate (Ke) remain constant.

The overall cost of capital under this approach is measured by :

$$Ko = \frac{\text{Net Operating Income}}{\text{Total value of the firm}}$$

The Net Operating Income Approach

The net operating income approach were developed by David Durand, on the other hand, contends that the capital structure does not matter, and that the firm cannot affect its overall cost of capital through leverage. Thus overall cost of capital remains constant. This results from the fact that as more debt is incurred, equity investors, in order to compensate for the increased financial risk, increase their capitalization rate of earnings in such a way as to cancel out the benefit derived from the use of debt, and the average cost remains unchanged. But it is possible that beyond a high level of leverage the cost of debt may increase.

Modigliani Miller Approach

Modigliani - Miller thesis of capital structure is akin to the Net Operating Income Approach. But, NOI approach is purely definitional ; it Jacks behavioural significance.2 The NOI approach does not provide operational justification for the irrelevance of capital structure. M.M. Thesis does support the NOI approach relating to the independence of the cost of capital of the degree of leverage at any level of debt equity ratio. It provides behavioral justification for constant overall cost of capital and therefore total value of the firm.

Traditional Approach

The traditional approach is midway between the NI and NOI approaches. It partakes some features of both these approaches. One of the foremost advocates of the traditional view is Ezra Solomon. The crux of the traditional view relating to leverage and valuation is that through judicious use of "debt to equity proportions", a firm can increase its total value and thereby reduce its overall cost of capital. The rationale is that debt is a relatively cheaper source of fund as compared to ordinary shares. With a change in leverage, that is by using more debt in the place of equity, a cheaper source of fund replaces a source of fund which involves, by comparison, a higher cost. This obviously causes a decline in the overall cost of capital and a rise in the market value of the firm.

DIVIDEND POLICIES

Introduction

The important aspect of dividend policy is to determine the amount of earnings to be distributed to shareholders and the amount to be retained in the firm . Retained earnings are the most significant internal sources of financing the growth of the firm. On the other hand, dividends may be considered desirable from the shareholders' point of view as they tend to increase their current return. Dividends, however, constitute the use of the firm's funds. Dividend policy involves the balancing of the shareholders' desire for current dividends and the firms' needs for funds for growth.

Forms of Dividends

Cash Dividends

The most common type of dividend is a cash dividend. Commonly, public companies pay regular cash dividends four times a year. As the name suggests, these are cash payments made directly to shareholders, and they are made in the regular course of business.

Stock dividend

An issue of bonus shares is the distribution of shares free of cost to existing shareholders. Bonus shares are issued in addition to the cash dividend and not in lieu of cash dividends. Hence, companies may supplement cash dividend by bonus issues.

Stock Split

A stock split is essentially the same thing as a stock dividend, except that a split is expressed as a ratio instead of a percentage. When a split is declared, each share is split up to create additional shares. For example, in a three-for-one stock split, each old share is split into three new shares.

Standard Method of Cash Dividend Payment

The decision to pay a dividend rests in the hands of the board of directors of the corporation. When a dividend has been declared, it becomes a debt of the firm and cannot be rescinded easily.

Stability of Dividend

It is considered a desirable policy by the management of most companies in practices. Many surveys have shown that shareholders also seem generally to favor this policy and value stable dividends higher than the fluctuating ones. All other things being the same, the stable dividend policy may have a positive impact on the market price of the share.

Three forms of such stability may be distinguished:

a) Constant dividend per share or dividend rate

b) Constant pay out.

c) Constant dividend per share plus extra dividend.

Factors Determination of Dividend Policies

1.Bond Indentures.

Debt contracts often limit dividend payments to earnings generated after the loan was granted. Also, debt contracts often stipulate that no dividends can be paid unless the current ratio, times-interest earned ratio, and other safety ratios exceed stated minimums.

2**. Preferred stock restrictions.**

Typically, common dividends cannot be paid if the company has omitted its preferred dividend. The preferred average must be satisfied before common dividends can be resumed.

3. **Impairment of capital rule.**

Dividend payments cannot exceed the balance sheet item "retained earnings." This legal restriction, known as the impairment of capital rule, is designed to protect creditors. Without the rule, a company that is in trouble might distribute most of its assets to stockholders and leave its debt holders out in the cold.

4. **Availability of cash.**

Cash dividends can be paid only with cash. Thus, a shortage of cash in the bank can restrict dividend payments. However, the ability to borrow can offset this factor.

5**. Penalty tax on improperly accumulated earnings**.

To prevent wealthy individuals from using corporations to avoid personal taxes, the Tax Code provides for a special surtax on improperly accumulated income. Thus, if the IRS can demonstrate that a firm's dividend payout ratio is being deliberately held down to help its stockholders avoid personal taxes, the firm is subject to heavy penalties. This factor is generally relevant only to privately owned firms.

6. **Number of profitable investment opportunities.**

If a firm typically has a large number of profitable investment opportunities, this will tend to produce a low target payout ratio, and vice versa if the firm's profitable investment opportunities are few in number.

7.Possibility of accelerating or delaying projects.

The ability to accelerate or postpone projects will permit a firm to adhere more closely to a stable dividend policy.

8. **Cost of selling new stock.**

If a firm needs to finance a given level of investment, it can obtain equity by retaining earnings or by issuing new common stock. If flotation costs (including any negative signaling effects of a stock offering) are high, ke will be well above Ks, making it better to set a low payout ratio and to finance through retention rather than through sales of new common stock. On the other hand, a high dividend payout ratio is more feasible for a firm whose flotation costs are low.

9. Flotation costs differ among firm

For example, the flotation percentage is generally higher for small firms, so they tend to set low payout ratios.

10. Ability to substitute debt for equity.

A firm can finance a given level of investment with either debt or equity. As noted above, low stock flotation costs permit a more flexible dividend policy because equity can be raised either by retaining earnings or by selling new stock. A similar situation holds for debt policy.

Dividend Theories and Behaviour

- Irrelevance of Dividend
- Relevance of Dividend

Irrelevance of Dividend

The dividend policy has no effect on the share price of the company. There is no relation between the dividend rate and value of the firm. Dividend decision is irrelevant of the value of the firm. Modigliani and Miller contributed a major approach to prove the irrelevance dividend concept.

Modigliani and Miller's Approach

According to MM, under a perfect market condition, the dividend policy of the company is irrelevant and it does not affect the value of the firm. "Under conditions of perfect markets, rational investors, absence of tax discrimination between dividend income and capital appreciation, given the firm's investment policy, its dividend policy may have no influence on the market price of shares".

Assumptions

MM approach is based on the following important assumptions:

- Perfect capital market.
- Investors are rational.
- There is no tax.
- The firm has a fixed investment policy.
- No risk or uncertainty

RELEVANCE OF DIVIDEND

According to this concept, dividend policy is considered to affect the value of the firm. Dividend relevance implies that shareholders prefer current dividend and there is no direct relationship between dividend policy and the value of the firm. Relevance of dividend concept is supported by two eminent persons like Walter and Gordon.

Walter’s Model

According to the Walter’s model, if $r > k$, the firm is able to earn more than what the shareholders could by reinvesting, if the earnings are paid to them. The implication of $r > k$ is that the shareholders can earn a higher return by investing elsewhere. If the firm has $r = k$, it is a matter of indifference whether earnings are retained or distributed

Assumptions

Walters model is based on the following important assumptions:

- The firm uses only internal finance.
- The firm does not use debt or equity finance.
- The firm has constant return and cost of capital.
- The firm has 100 recent payout.
- The firm has constant EPS and dividend.
- The firm has a very long life.

Walter has evolved a mathematical formula for determining the value of market share.

$$P = (D + (r / Ke)(E - D)) / Ke$$

P = Market price of an equity share; D = Dividend per share; r = Internal rate of return

E = Earning per share; Ke = Cost of equity capita

Gordon’s Model

Myron Gorden suggests one of the popular models which assume that dividend policy of a firm affects its value, and it is based on the following important assumptions:

- ❖ The firm is an all equity firm.
- ❖ The firm has no external finance.
- ❖ Cost of capital and return are constant.
- ❖ The firm has perpetual life.
- ❖ There are no taxes.
- ❖ Constant relation ratio ($g = br$).

Cost of capital is greater than the growth rate ($Ke > br$).

Gordon’s model can be proved with the help of the following formula:

$$P = E\,(1 - b)\,/\,Ke - br)$$

P = Price of a share; E = Earnings per share

1 – b = D/p ratio (i.e., percentage of earnings distributed as dividends)

Ke = Capitalization rate; br = Growth rate = rate of return on investment of an all equity firm

Working Capital Management

Introduction

Working capital can be understood as a measure of both a company's efficiency and its shor tterm financial health. For a layman, it simply means the difference between the current assets and current liabilities. It is the firm's holdings of current, or short-term, assets . Working capital is generally divided in two types, viz. gross working capital and net working capital. Gross Working Capital (GWC) is nothing but the total current or circulating assets. Net working capital, NWC (current assets minus current liabilities), provides an accurate assessment of the liquidity position of firm.

Concept of Working Capital

Working capital typically means the firm's holdings of current, or short-term, assets such as cash, receivables, inventory, and marketable securities. 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. In other words working capital is the amount of funds necessary to cover the cost of operating the enterprise.

Types of Working Capital

Permanent working capital

Permanent working capital otherwise called as **Fixed Working Capital**. Tandon committee has referred to this type of working capital as **Hard Core Working Capital**. Permanent working capital implies the base investment amount in all types of current resources which is respected at all times to carry on business activities.

Temporary Working Capital

It is otherwise called as Fluctuating or Variable Working Capital. There is a close relationship prevailing between temporary working capital and the level of production and sales. There is no uniform production and sales throughout the year. If heavy order is received for production and there is a large amount of credit sales, there is a need of more amount of temporary working capital.

Gross Working Capital

The gross working capital, simply called as working capital refers to the firm's investment in current assets. Current assets are the assets, which can be converted into cash within an accounting year or operating cycle.

Net Working Capital

Net working capital refers to the difference between current assets and current liabilities. Current liabilities are those claims of outsiders, which are expected to mature for payment within an accounting year. Net working capital may be positive or negative.

Negative Working Capital

Sometimes, the value of current assets is less than the current liabilities, it shows negative working capital. If such type of situation arise, the firm is going to meet the financial crisis very shortly.

Reserve Working Capital

It is otherwise called as Cushion Working Capital. It refers to the short term financial arrangement made by the business units to meet uncertain changes or to meet uncertainties.

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Regular Working Capital

The minimum amount of working capital to be maintained in normal condition is called Regular Working Capital

Seasonal Working Capital

Some products have seasonal demand. Seasonal demand arises due to festival. In this way, seasonal working capital means an amount of **working capital maintained to meet the seasonal demand** of the product.

Special Working Capital

Special programmes may be conducted for business development. The programmes may be advertisement campaign, sales promotion activities, product development activities, marketing research activities, launching of new products, expansion of markets and the like. Therefore, special working capital means an amount of working capital maintained to meet the expenses of special programmes of the company.

Motives for Holding Cash

The Transactions Motive

Balances held for transaction purposes allow the firm to meet its cash needs that arise in the ordinary course of doing business. In Figure 17-1, cash would be used to meet the irregular outflows as well as the planned acquisition of fixed assets and inventories.

The Precautionary Motive

Precautionary balances serve as a buffer. This motive for holding cash relates to the maintenance of balances used to satisfy possible, but as yet unknown, needs.

The Speculative Motive

Cash is held for speculative purposes in order to take advantage of potential profit-making situations

Receivable Management

Introduction

Accounts receivable typically comprise more than 25 percent of a firm's assets. The term receivables is described as debt owed to the firm by the customers resulting from the sale of goods or services in the ordinary course of business. There are the funds blocked due to credit sales. Receivables management denotes to the decision a business makes regarding to the overall credit, collection policies and the evaluation of individual credit applicants. Receivables Management is also known as trade credit management.

Objectives of receivables management

The objective of Receivables Management is to promote sales and profits until that point is reached where the return on investment in further funding receivables is less than the cost of funds raised to finance that additional credit i.e. cost of capita. Management of Accounts Receivables is quite expensive. The following are the main costs related with accounts receivables management:

Advantages of accounts receivable management

- **Increased Sales**: Offering goods or services on credit enhances sales, by holding old customers and attraction potential customers.
- **Increased Market Share**: When the firm is able to maintain old customers and attract new customers automatically market share will be bigger to the extent new sales.
- **Increase in profits**: Increase sales, leads to increase in profits, because it need to produce more products with a given fixed cost and sales of products with a given sales network in both cost per unit comes down and the profit will be better.

Management of Inventory

Introduction

Inventory management is basically related to task of controlling the assets that are produced to be sold in the normal course of the firm's procedures. In supply chain management, major variable is to effectively manage inventory. The significance of inventory management to the company depends on the extent of its inventory investment.

objectives of inventory management

- The operational objective is to uphold enough inventory, to meet demand for product by efficiently organizing the firm's production and sales operations.
- Financial interpretation is to minimize unproductive inventory and reduce inventory, carrying costs.

Components of inventory management

- Raw materials:

Raw materials are those inputs that are transformed into completed goods throughout manufacturing process. Those form a major input for manufacturing a product. In other words, they are very much needed for uninterrupted production.

- Work-in-process:

Work-in-process is a stage of stocks between raw materials and finished goods. Work-in-process inventories are semi-finished products. They signify products that need to undergo some other process to become finished goods.

- Finished products:

Finished products are those products which are totally manufactured and company can immediately sell to customers. The stock of finished goods provides a buffer between production and market.

- Stores and spares:

It comprises of office and plant cleaning materials like soap, brooms, oil, fuel, light, bulbs and are purchased and stored for the purpose of maintenance of machinery.

Merits of Inventory Management

1. Inventory management guarantees adequate supply of materials and stores to minimize stock outs and shortages and avoid costly interruption in operations.
2. It keeps down investment in inventories, inventory carrying costs, and obsolescence losses to the minimum.
3. It eases purchasing economies throughout the measurement of requirements on the basis of recorded experience.
4. It removes duplication in ordering stock by centralizing the source from which purchase requisition emanate.
5.It allows better utilization of available stock by enabling inter-department transfers within a firm.

Demerits of Holding Inventory

- Price decline
- Product deterioration
- Product obsolescence

THANK YOU