

## FINANCIAL MANAGEMENT

**UNIT- I** Financial Management: Meaning and Scope of Finance Functions, Goals: Profit Maximization and Wealth Maximization -Organization of Finance Function.

### INTRODUCTION

Finance is called “The science of money”. It studies the principles and the methods of obtaining, control of money from those who have saved it, and of administering it by those into whose control it passes. It is the process of conversion of accumulated funds to productive use. Financial management is the science of money management .It is that managerial activity which is concerned with planning and controlling of the firms financial resources. In other words it is concerned with acquiring, financing and managing assets to accomplish the overall goal of a business enterprise.

### MEANING, DEFINITION AND NATURE OF FINANCIAL MANAGEMENT:

#### Meaning and Definition

Financial management is that managerial activity which is concerned with the planning and controlling of the firm’s financial resources. In other words it is concerned with acquiring, financing and managing assets to accomplish the overall goal of a business enterprise (mainly to maximise the shareholder’s wealth).

“Financial management is concerned with the efficient use of an important economic resource, namely capital funds” - Solomon Ezra & J. John Pringle.

“Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient business operations”- J.L. Massie.

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

1. 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.
2. 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.
3. Dividend decision - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
  - a. Dividend for shareholders- Dividend and the rate of it has to be decided.
  - b. Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

## **Objectives of Financial Management**

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

## **Functions of Financial Management**

1. **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.
2. **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.
3. **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-
  - a. Issue of shares and debentures
  - b. Loans to be taken from banks and financial institutions
  - c. Public deposits to be drawn like in form of bonds.

Choice of factor will depend on relative merits and demerits of each source and period of financing.

4. **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.
5. **Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:
  - a. Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
  - b. Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.

6. **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintainance of enough stock, purchase of raw materials, etc.
7. **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

### **Profit Maximization**

Profit Maximization is the capability of the firm in producing maximum output with the limited input, or it uses minimum input for producing stated output. It is termed as the foremost objective of the company.

It has been traditionally recommended that the apparent motive of any business organisation is to earn a profit, it is essential for the success, survival, and growth of the company. Profit is a long term objective, but it has a short-term perspective i.e. one financial year.

Profit can be calculated by deducting total cost from total revenue. Through profit maximization, a firm can be able to ascertain the input-output levels, which gives the highest amount of profit. Therefore, the finance officer of an organisation should take his decision in the direction of maximizing profit although it is not the only objective of the company.

### **Wealth Maximization**

Wealth maximization is the ability of a company to increase the market value of its common stock over time. The market value of the firm is based on many factors like their goodwill, sales, services, quality of products, etc.

It is the versatile goal of the company and highly recommended criterion for evaluating the performance of a business organisation. This will help the firm to increase their share in the market, attain leadership, and maintain consumer satisfaction and many other benefits are also there.

It has been universally accepted that the fundamental goal of the business enterprise is to increase the wealth of its shareholders, as they are the owners of the undertaking, and they buy the shares of the company with the expectation that it will give some return after a period. This states that the financial decisions of the firm should be taken in such a manner that will increase the Net Present Worth of the company's profit. The value is based on two factors:

1. Rate of Earning per share
2. Capitalization Rate

**The fundamental differences between profit maximization and wealth maximization is explained in points below:**

1. The process through which the company is capable of increasing earning capacity known as Profit Maximization. On the other hand, the ability of the company in increasing the value of its stock in the market is known as wealth maximization.
2. Profit maximization is a short term objective of the firm while the long-term objective is Wealth Maximization.
3. Profit Maximization ignores risk and uncertainty. Unlike Wealth Maximization, which considers both.
4. Profit Maximization avoids time value of money, but Wealth Maximization recognises it.
5. Profit Maximization is necessary for the survival and growth of the enterprise. Conversely, Wealth Maximization accelerates the growth rate of the enterprise and aims at attaining the maximum market share of the economy.

**UNIT- II Capitalisation – over capitalization- Under capitalization- Capital Structure Planning –Meaning and Scope–Approaches: Net Income Approach–Net Operating Income Approach MM Approach –Arbitrage Process –Traditional Approach –Indifference Point.**

### **CAPITALISATION,CAPITAL STRUCTURE,FINANCIAL STRUCTURE**

Capitalisation is a quantitative aspect of the financial planning of an enterprise, capital structure is concerned with the qualitative aspect. Capitalisation refers to the total amount of securities issued by a company while capital structure refers to the kind of securities and the proportionate amount that make up capitalisation. Financial structure refers to all the financial resources marshalled by the firm ,short as well as long –term ,and all forms of debt and equity.

#### **Capital and Capitalisation**

The term capital refers to the total investment of a company in money, tangible and intangible assets. It is the total wealth of a company . The term Capitalisation is used only in relation to companies and not in relation to partner ship firms or sole- proprietary organisations. Capitalisation refers to the par value of securities i.e. share, debenture &reserves.

Over Capitalisation-It refers to that state of affairs where earning of a company do not justify the amount of capital invested in its business.

Under Capitalisation-It occurs when a companies actual capitalisation is lower than its proper capitalisation as warranted by its earning capacity.

Fair Capitalisation-It is neither over capitalisation nor under capitalisation.

The term capital structure refers to the relationship between the various long –term forms of financing such as debenture ,preference share capital and equity share capital .Financing the firm’s asset is a very crucial problem in every business and as a general rule there should be a proper mix of debt and equity

capital in financing the firms assets. The use of long term fixed interest bearing debt and preference share capital along with equity share is called financial leverage or trading on equity.

Capital gearing means the ratio between the various types of securities in the capital structure of the company .A company is said to be in high gear ,when it has a proportionately higher/large issue of debentures and preference shares for raising the long term resources ,whereas low-gear stands for a proportionately large issue of equity shares.

### **Capital Structure Theory**

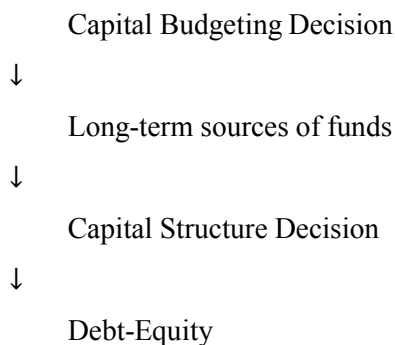
The capital structure of a company refers to a combination of the long-term finances used by the firm. The theory of capital structure is closely related to the firm's cost of capital. The decision regarding the capital structure or the financial leverage or the financing is based on the objective of achieving the maximization of shareholders wealth. To design capital structure, we should consider the following two propositions:

- (i) Wealth maximization is attained.
- (ii) Best approximation to the optimal capital structure.

### **Factors Determining Capital Structure**

- (1) Minimization of Risk :
  - (a) Capital structure must be consistent with business risk.
  - (b) It should result in a certain level of financial risk.
- (2) Control : It should reflect the management's philosophy of control over the firm.
- (3) Flexibility : It refers to the ability of the firm to meet the requirements of the changing situations.
- (4) Profitability : It should be profitable from the equity shareholders point of view.
- (5) Solvency : The use of excessive debt may threaten the solvency of the company.
- (6) Financial leverage or Trading on equity.
- (7) Cost of capital.
- (8) Nature and size of the firm.

### **Process of Capital Structure Decisions**



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Effect on Cost of Capital

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Value of the Firm

### **THEORIES OF CAPITAL STRUCTURE:**

Equity and debt capital are the two major sources of long-term funds for a firm. The theories of capital structure suggest the proportion of equity and debt in the capital structure.

#### **Assumptions**

- (i) There are only two sources of funds, i.e., the equity and the debt, having a fixed interest.
- (ii) The total assets of the firm are given and there would be no change in the investment decisions of the firm.
- (iii) EBIT (Earnings Before Interest & Tax)/NOP (Net Operating Profits) of the firm are given and is expected to remain constant.
- (iv) Retention Ratio is NIL, i.e., total profits are distributed as dividends. [100% dividend pay-out ratio]
- (v) The firm has a given business risk which is not affected by the financing decision.
- (vi) There is no corporate or personal taxes.
- (vii) The investors have the same subjective probability distribution of expected operating profits of the firm.
- (viii) The capital structure can be altered without incurring transaction costs.

In discussing the theories of capital structure, we will consider the following notations : E =

Market value of the Equity

D = Market value of the Debt

V = Market value of the Firm = E + D I =

Total Interest Payments

T = Tax Rate

EBIT/NOP = Earnings before Interest and Tax/Net Operating Profit PAT =

Profit After Tax

D<sub>0</sub> = Dividend at time 0 (i.e. now)

D<sub>1</sub> = Expected dividend at the end of Year 1. P<sub>0</sub>

= Current Market Price per share

P<sub>1</sub> = Expected Market Price per share at the end of Year 1.

#### **Different Theories of Capital Structure**

- (1) Net Income (NI) approach
- (2) Net Operating Income (NOI) Approach

- (3) Traditional Approach
- (4) Modigliani-Miller Model
  - (a) without taxes
  - (b) with taxes.

**Net Income Approach** \_\_\_\_\_

As suggested by David Durand, this theory states that there is a relationship between the Capital Structure and the value of the firm.

Assumptions

- (1) Total Capital requirement of the firm are given and remain constant
- (2)  $K_d < K_e$
- (3)  $K_d$  and  $K_e$  are constant \_\_\_\_\_
- (4)  $K_o$  decreases with the increase in leverage

**Net Operating Income (NOI) Approach**

According to David Durand, under NOI approach, the total value of the firm will not be affected by the composition of capital structure.

Assumptions

- (1)  $K_o$  and  $K_d$  are constant.
- (2)  $K_e$  will change with the degree of leverage.
- (3) There is no tax.

**Traditional Approach**

It takes a mid-way between the NI approach and the NOI approach

Assumptions

- (i) The value of the firm increases with the increase in financial leverage, upto a certain limit only.
- (ii)  $K_d$  is assumed to be less than  $K_e$ .

**Modigliani – Miller (MM) Hypothesis**

The Modigliani – Miller hypothesis is identical with the Net Operating Income approach. Modigliani and Miller argued that, in the absence of taxes the cost of capital and the value of the firm are not affected by the changes in capital structure. In other words, capital structure decisions are irrelevant and value of the firm is independent of debt – equity mix.

**Basic Propositions**

M - M Hypothesis can be explained in terms of two propositions of Modigliani and Miller. They are :

- i. The overall cost of capital (KO) and the value of the firm are independent of the capital structure. The total market value of the firm is given by capitalising the expected net operating income by the rate appropriate for that risk class.
- ii. The financial risk increases with more debt content in the capital structure. As a result cost of equity ( $K_e$ ) increases in a manner to offset exactly the low – cost advantage of debt. Hence, overall cost of capital remains the same.

### **Assumptions of the MM Approach**

1. There is a perfect capital market. Capital markets are perfect when
  - i) investors are free to buy and sell securities,
  - ii) they can borrow funds without restriction at the same terms as the firms do,
  - iii) they behave rationally,
  - iv) they are well informed, and
  - v) there are no transaction costs.
2. Firms can be classified into homogeneous risk classes. All the firms in the same risk class will have the same degree of financial risk.
3. All investors have the same expectation of a firm's net operating income (EBIT).
4. The dividend payout ratio is 100%, which means there are no retained earnings.

**UNIT- III Capital Budgeting–Concept and Importance –Capital Budgeting Appraisal Methods: Pay Back Method –Discounted Cash Flow Method: NPV Method, Excess Present Value Index and IRR Method -Return on Investment Method.**

### **CAPITAL BUDGETING PROCESS :**

A Capital Budgeting decision involves the following process :

- (1) Identification of investment proposals.
- (2) Screening the proposals.
- (3) Evaluation of various proposals.
- (4) Fixing priorities.
- (5) Final approval and preparation of capital expenditure budget.
- (6) Implementing proposal.
- (7) Performance review.

The overall objective of capital budgeting is to maximise the profitability of a firm or the return on



investment. There are many methods of evaluating profitability of capital investment proposals.

## **METHODS OF CAPITAL BUDGETING OR EVALUATION OF INVESTMENT PROPOSALS (INVESTMENT APPRAISAL TECHNIQUES)**

The various commonly used methods are as follows.

### **I. Traditional methods**

(1) Pay back period method or pay out or pay off method.(PBP)

(2) Accounting Rate of Return method or Average Rate of Return. (ARR)

### **II. Time adjusted method or discounted method**

(3)Net Present Value method.(NPV)

(4)Profitability Index method (PI) (5)Internal Rate of Return method (IRR) (6)Net Terminal Value method (NTV)

#### **(1) Pay back period method or pay out or pay off method.(PBP)**

The basic element of this method is to calculate the recovery time, by year wise accumulation of cash inflows (inclusive of depreciation) until the cash inflows equal the amount of the original investment. The time taken to recover such original investment is the “payback period” for the project.

“The shorter the payback period, the more desirable a project”.

The pay back period can be calculated in two different situation as follows-

#### **(a) When annual cash inflow are equal**

$$\text{Pay back period} = \frac{\text{Original cost of the project (cash outlay)}}{\text{Annual net cash inflow (net earnings)}}$$

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**(b) When annual cash inflows are unequal**

It is ascertained by cumulating cash inflows till the time when the cumulative cash inflows become equal to initial investment.

$$\text{Pay back period} = Y + \frac{B}{C}$$

Y=No of years immediately preceding the year of final recovery.

B=Balance amount still to be recovered.

C=Cash inflow during the year of final recovery.

**Merits of Pay back period :**

- (1) No assumptions about future interest rates.
- (2) In case of uncertainty in future, this method is most appropriate.
- (3) A company is compelled to invest in projects with shortest payback period, if capital is a constraint.
- (4) It is an indication for investments.
- (5) Ranking projects as per constraints.

**Demerits of Pay back period:**

- (1)Cash generation beyond payback period is ignored.
- (2)The timing of returns and the cost of capital is not considered.
- (3)The traditional payback method does not consider the salvage value of an investment.
- (4)Percentage Return on the capital invested is not measured.
- (5)Projects with long payback periods are characteristically those involved in long-term planning, which are ignored in this approach.

**(2) Accounting Rate of Return method or Average Rate of Return (ARR)**

This method measures the increase in profit expected to result from investment.

It is based on accounting profits and not cash flows.

$$\text{ARR} = \frac{\text{Average income or return}}{100}$$

Average investment

$$\text{Average investment} = \frac{\text{Original investment} + \text{Salvage value}}{2}$$

2

### **Merits of ARR**

- (1) This method considers all the years in the life of the project.
- (2) It is based upon profits and not concerned with cash flows.
- (3) Quick decision can be taken when a number of capital investment proposals are being considered.

### **Demerits of ARR**

- (1) Time Value of Money is not considered.
- (2) It is biased against short-term projects.
- (3) The ARR is not an indicator of acceptance or rejection, unless the rates are compared with the arbitrary management target.
- (4) It fails to measure the rate of return on a project even if there are uniform cash flows.

### **(3) Net Present Value method.(NPV)**

**NPV= Present Value of Cash Inflows – Present Value of Cash Outflows**

The discounting is done by the entity's weighted average cost of capital.

The discounting factors is given by :  $n \frac{1}{(1+i)^n}$

1

Where

i = rate of interest per annum

n = no. of years over which discounting is made.

### **Merits of Net Present Value method**

- (1) It recognises the Time Value of Money.
- (2) It considers total benefits during the entire life of the Project.
- (3) This is applicable in case of mutually exclusive Projects.
- (4) Since it is based on the assumptions of cash flows, it helps in determining Shareholders Wealth.

### **Demerits of Net Present Value method**

- (1) This is not an absolute measure.
- (2) Desired rate of return may vary from time to time due to changes in cost of capital.
- (3) This Method is not effective when there is disparity in economic life of the projects.
- (4) More emphasis on net present values. Initial investment is not given due importance.

### **(4) Profitability Index method (PI)**

$$\text{Profitability Index} = \frac{\text{P.V. of cash outflow}}{\text{P.V. of cash inflow}}$$

If P.I > 1, project is accepted

P.I < 1, project is rejected

The Profitability Index (PI) signifies present value of inflow per rupee of outflow. It helps to compare projects involving different amounts of initial investments.

### 5) Internal Rate of Return method (IRR)

Internal Rate of Return is a percentage discount rate applied in capital investment decisions which brings the cost of a project and its expected future cash flows into equality, i.e., NPV is zero.

#### Merits of Internal Rate of Return method :

- (i) The Time Value of Money is considered.
- (ii) All cash flows in the project are considered.

#### Demerits of Internal Rate of Return method

- (i) Possibility of multiple IRR, interpretation may be difficult.
- (ii) If two projects with different inflow/outflow patterns are compared, IRR will lead to peculiar situations.
- (iii) If mutually exclusive projects with different investments, a project with higher investment but lower IRR contributes more in terms of absolute NPV and increases the shareholders' wealth.

When evaluating mutually exclusive projects, the one with the highest IRR may not be the one with the best NPV.

The conflict between NPV & IRR for the evaluation of mutually exclusive projects is due to the reinvestment assumption:

- NPV assumes cash flows reinvested at the cost of capital.
- IRR assumes cash flows reinvested at the internal rate of return.

The reinvestment assumption may cause different decisions due to :

- Timing difference of cash flows.
- Difference in scale of operations.
- Project life disparity.

### 6) Net Terminal Value method (NTV)

**Assumption :**

- (1) Each cash flow is reinvested in another project at a predetermined rate of interest.
- (2) Each cash inflow is reinvested elsewhere immediately after the completion of the project.

Decision-making

If the P.V. of Sum Total of the Compound reinvested cash flows is greater than the P.V. of the outflows of the project under consideration, the project will be accepted otherwise not.

**UNIT- IV** Cost of Capital –Concept, Importance -Classification: Cost of Debt – Cost of Equity –Cost of Retained Earnings–Weighted Average Cost of Capital.

### **COST OF CAPITAL AND FINANCING DECISION.**

James C. Van Horne: The cost of capital is “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”.

Soloman Ezra : “Cost of Capital is the minimum required rate of earnings or the cut-off rate of capital expenditure”.

It is the discount rate /minimum rate of return/opportunity cost of an investment.

### **IMPORTANCE OF COST OF CAPITAL :**

The cost of capital is very important in financial management and plays a crucial role in the following areas:

- 1) **Capital budgeting decisions:** The cost of capital is used for discounting cash flows under Net Present Value method for investment proposals. So, it is very useful in capital budgeting decisions.
- 2) **Capital structure decisions:** An optimal capital structure is that structure at which the value of the firm is maximum and cost of capital is the lowest. So, cost of capital is crucial in designing optimal capital structure.
- 3) **Evaluation of financial performance:** Cost of capital is used to evaluate the financial performance of top management. The actual profitability is compared to the expected and actual cost of capital of funds and if profit is greater than the cost of capital the performance may be said to be satisfactory.
- 4) **Other financial decisions:** Cost of capital is also useful in making such other financial decisions as dividend policy, capitalization of profits, making the rights issue, etc.

**Explicit and Implicit Cost:** *Explicit cost* of any source of finance is the discount rate which equates the present value of cash inflows with the present value of cash outflows. It is the internal rate of return.

*Implicit cost* also known as the opportunity cost is the opportunity foregone in order to take up a particular project. For example, the implicit cost of retained earnings is the rate of return available to shareholders by investing the funds elsewhere.

### **ESTIMATION OF COMPONENTS OF COST OF CAPITAL**

Components of cost of capital includes individual source of finance in business. From the viewpoint of capital budgeting decisions, the long term sources of funds are relevant as they constitute the major sources

therefore components include-of financing the fixed assets. In calculating the cost of capital,

1. Long term debt (including Debentures)
2. Preference capital
3. Equity Capital.
4. Retained Earnings
5. Weighted Average Cost of Capital
6. Marginal Cost of Capital

**1. Cost of Debt (kd) ( Long term debt (including Debentures))**

Debt may be perpetual or redeemable debt. Moreover, it may be issued at par, at premium or discount. The computation of cost of debt in each is explained below.

**Perpetual / irredeemable debt :**

$K_d = \text{Cost of debt before tax} = I/NP$

$K_d = \text{Cost of debt; } I = \text{interest; } NP = \text{Net Proceeds}$

$k_d(\text{after-tax}) =$

$$\frac{I(1-t)}{NP}$$

Where t = tax rate

**2. Cost of Preference Capital (kP)**

In case of preference share dividend are payable at a fixed rate. However, the dividends are allowed to be deducted for computation of tax. So no adjustment for tax is required. Just like debentures, preference share may be perpetual or redeemable. Further, they may be issued at par, premium or discount.

**Perpetual Preference Capital**

i) If issued at par ;  $K_p = D/P$

$K_p = \text{Cost of preference capital } D$   
 $= \text{Annual preference dividend } P =$   
 $\text{Proceeds at par value}$



ii) If issued at premium or discount

$$K_p = D/NP \quad \text{Where NP = Net Proceeds.}$$

### **Dividend yield plus Growth in dividend methods**

According to this method, the cost of equity is determined on the basis of the expected dividend rate plus the rate of growth in dividend. This method is used when dividends are expected to grow at a constant rate.

### **Earnings Yield Method –**

According to this approach, the cost of equity is the discount rate that capitalizes a stream of future earnings to evaluate the shareholdings. It is computed by taking earnings per share (EPS) into consideration. It is calculated as :

$$i) K_e = \text{Earnings per share} / \text{Net proceeds} = \text{EPS} / \text{NP} \text{ [For new share]}$$

$$K_e = \text{EPS} / \text{MP} \text{ [ For existing equity]}$$

### **4. Cost of Retained Earnings (Kr)**

Retained earnings refer to undistributed profits of a firm. Out of the total earnings, firms generally distribute only part of them in the form of dividends and the rest will be retained within the firms. Since no dividend is required to be paid on retained earnings, it is stated that 'retained earnings carry no cost'. But this approach is not appropriate. Retained earnings have the opportunity cost of dividends in alternative investment, which becomes cost of retained earnings. Hence, shareholders expect a return on retained earnings at least equity.

$$K_r = K_e = D/NP + g$$

However, while calculating cost of retained earnings, two adjustments should be made : a) Income-tax adjustment as the shareholders are to pay some income tax out of dividends, and b) adjustment for brokerage cost as the shareholders should incur some brokerage cost while investing dividend income. Therefore, after these adjustments, cost of retained earnings is calculated as :

$$K_r = K_e (1-t)(1-b) \text{ Where, } K_r = \text{cost of retained earnings}$$
$$K_e = \text{Cost of equity}$$

t = rate of tax

b = cost of purchasing new securities or brokerage cost.

### **5) Weighted Average Cost of Capital**

It is the average of the costs of various sources of financing. It is also known as composite or overall or average cost of capital.

After computing the cost of individual sources of finance, the weighted average cost of capital is calculated by putting weights in the proportion of the various sources of funds to the total funds. Weighted average cost of capital is computed by using either of the following two types of weights:

- 1) Market value 2) Book Value

Market value weights are sometimes preferred to the book value weights as the market value represents the true value of the investors. However, market value weights suffer from the following limitations:

- i) Market value are subject to frequent fluctuations.
- ii) Equity capital gets more importance, with the use of market value weights.

Moreover, book values are readily available.

Average cost of capital is computed as followings:

$$K_w = \frac{\sum Xw}{\sum w}$$

Where,  $K_w$  = weighted average cost of capital  $X$

= cost of specific sources of finance

$W$  = weights (proportions of specific sources of finance in the total)

The following steps are involved in the computation of weighted average cost of capital :

- i) Multiply the cost of each sources with the corresponding weight.
- ii) Add all these weighted costs so that weighted average cost of capital is obtained.

### 6) Marginal Cost of Capital

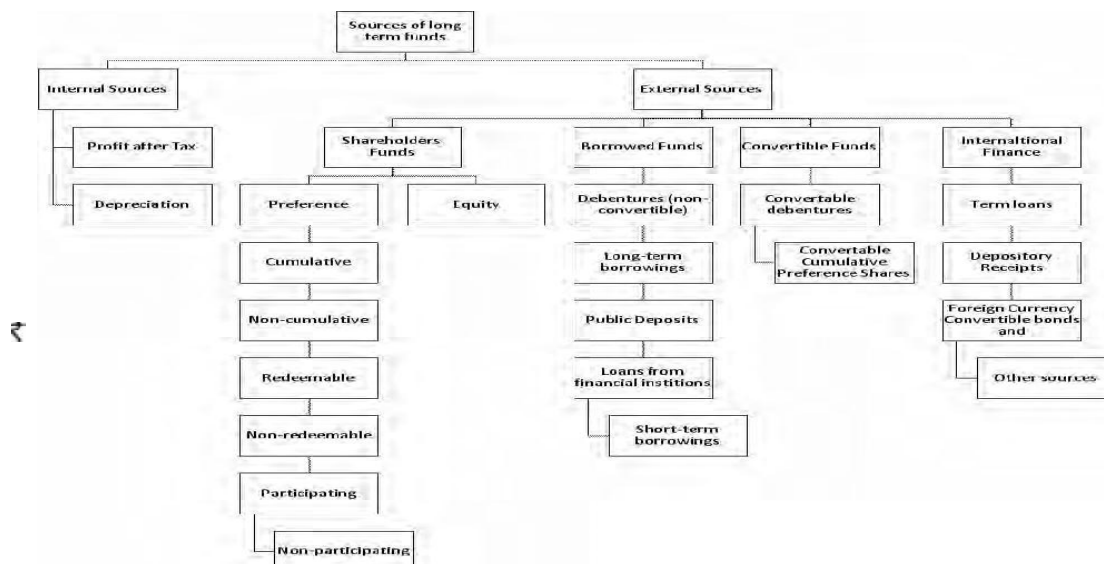
An average cost is the combined cost or weighted average cost of various sources of capital. Marginal cost refers to the average cost of capital of new or additional funds required by a firm. It is the marginal cost which should be taken into consideration in investment decisions.

### LONG TERM SOURCES OF FUNDS:

Companies raise long term funds from the capital markets. Funds available for a period of less than one year are short term funds. With the increase in cross-border transactions, international sources of funds

are also available. An effective trade-off between the domestic funds and international funds shall contribute towards increasing profitability and wealth maximisation

To enable the investments, creation of assets and infrastructure, long term sources of funds. They are: an organisation require



## 1. Equity Share Capital

Equity share capital is a basic source of finance for any Company. It represents the ownership interest in the company. The characteristics of equity share capital are a direct consequence of its position in the company's control, income and assets. Equity share capital does not have any maturity nor there any compulsion to pay dividend on it. The equity share capital provides funds, more or less, on a permanent basis. It also works as a base for creating the debt and loan capacity of the firm. The advantages and limitations of equity share capital may be summarized as follows

### Advantages of Equity Share Financing

- Since equity shares do not mature, it is a permanent source of fund. However, a company, if it so desires, can retire shares through buy-back as per the guidelines issued by the SEBI.
- The new equity share capital increases the corporate flexibility from the point of view of capital structure planning. One such strategy may be to retire debt financing out of the funds received from the issue of equity capital.
- Equity share capital does not involve any mandatory payments to shareholders.

d. It may be possible to make further issue of share capital by using a right offering. In general, selling right shares involves no change in the relationship between ownership and control. Existing shareholders can maintain their proportionate holding by exercising their pre-emptive right.

### **Limitations of Equity Share Financing**

- a. The equity share capital has the highest specific cost of capital among all the sources. This necessitates that the investment proposals should also have equally high rate of return.
- b. Equity dividends are paid to the shareholders out of after-tax profits. These dividends are not tax deductible, rather imply a burden of Corporate Dividend tax on the company.
- c. At times, the new issue of equity capital may reduce the EPS and thus may have an adverse effect on the market price of the equity share.
- d. Excessive issue of equity share can dilute the ownership of the Company.

## **2. Preference Share Capital**

The preference share capital is also owner's capital but has a maturity period. In India, the preference shares must be redeemed within a maximum period of 20 years from the date of issue. The rate of dividend payable on preference shares is also fixed. As against the equity share capital, the preference shares have two references: (i) Preference with respect to payment of dividend, and (ii) Preference with reference to repayment of capital in case of liquidation of company.

However, the preference share capital represents an ownership interest and not a liability of the company. The preference shareholders have the right to receive dividends in priority over the equity shareholders. Indeed, it is this preference which distinguishes preference shares from equity shares. A dividend need not necessarily be paid on either type of shares. However, if the directors want to pay equity dividend, then the full dividend due on the preference shares must be paid first. Failure to meet commitment of preference dividend is not a ground for liquidation. The advantages and disadvantages of the preference share capital are as follows:

### **Advantages of Preference Share Financing**

- a. The preference shares carry limited voting right though they are a part of the capital. Thus, these do not present a major control or ownership problem as long as the dividends are paid to them.
- b. As an instrument of financing, the cost of capital of preference shares is less than that of equity shares.
- c. The preference share financing may also provide a hedge against inflation because the fixed financial

commitment which is unaffected by the inflation.

d. As there is no legal compulsion to pay preference dividend, a company does not face liquidation or other legal proceedings if it fails to pay the preference dividends.

### **Limitations of Preference Share Financing**

a. The cost of capital of preference shares is higher than cost of debt.

b. Though there is no compulsion to pay preference dividend, yet the non-payment may adversely affect the market price of the equity shares and hence affect the value of the firm.

c. The compulsory redemption of preference shares after 20 years will entail a substantial cash out

d. tflow from the company.

e. If the company is not able to earn a return at least equal to the cost of preference share capital, then it may result in decrease in EPS for the equity shareholders.

### **3. Debentures**

A bond or a debenture is the basic debt instrument which may be issued by a borrowing company for a price which may be less than, equal to or more than the face value. A debenture also carries a promise by the company to make interest payments to the debenture-holders of specified amount, at specified time and also to repay the principal amount at the end of a specified period. Since the debt instruments are issued keeping in view the need and cash flow profile of

the company as well as the investor, there have been a variety of debt instruments being issued by companies in practice. In all these instruments, the basic features of being in the nature of a loan are not dispensed with and, therefore, these instruments have some or the other common features as follows:

(i) Credit Instrument—A debenture-holder is a creditor of the company and is entitled to receive payments of interest and the principal and enjoys some other rights.

(ii) Interest Rate— In most of the cases, the debt securities promise a rate of interest payable periodically to the debt holders. The rate of interest is also denoted as coupon rate.

(iii) Collateral— Debt issue may or may not be secured and, therefore, debentures or other such securities may be called secured debentures or unsecured debentures.

(iv) Maturity Date— All debt instruments have a fixed maturity date, when these will be repaid or redeemed in the manner specified.

(v) Voting Rights— As the debt holders are creditors of the company, they do not have any voting right in normal situations.

(vi) Face Value— every debt instrument has a face value as well as a maturity value.

(vii) Priority in Liquidation— In case of liquidation of the company, the claim of the debt holders is settled in priority over all shareholders and, generally, other unsecured creditors also.

**In practice, different types of debentures have been issued. These are :**

(a) Convertible Debentures— In this case, the debentures are converted, fully or partially, into equity shares some time after the date of issue.

(b) Non-convertible Debentures— These debentures remain a debt security till maturity. Interest is paid on these debentures as per terms and conditions.

(c) Innovative Debentures— Companies have come forward to issue a debt security with different attractive and innovative features. Some of these are - Secured

Premium Notes, Optionally Convertible Debentures, Triple Option Convertible Debentures, etc. Financial Institutions such as IDBI have issued Deep

Discount Bonds (DDBs) from time to time to procure funds for a longer period.

#### **4. Lease and Hire Purchase**

Instead of procuring funds, and purchasing the equipment, a firm can acquire the asset itself on lease. In this case, the asset is financed by the lessor but the lessee gets the asset for use. In case of hire purchase, the assets are acquired on credit and payments are made as per terms and conditions.

#### **5. Term Loans**

This is also an important source of long-term financing. There are different financial institutions (National level as well as State level) which provide financial assistance for taking up projects. These can be broadly divided into All India Financial Institutions and State level Financial Institutions. The All India Institutions are:-

i) Industrial Finance Corporation of India, (IFCI)

ii) Industrial Credit and Investment Corporation in India (ICICI),

iii) Industrial Development Bank of India (IDBI),

iv) Life Insurance Corporation of India,

v) Industrial Reconstruction Corporation of India,

vi) Unit Trust of India,

vii) National Small Industries Corporation Ltd.(NSIC)

The state level institutions are the State Finance Corporations and the State Industrial Development Corporations.

## **6. Official Foreign Source of Finance**

1. Foreign Collaboration: In India joint participation of foreign and domestic capital has been quite common in recent years. Foreign collaboration could be either in the form of joint participation between private firms, or between foreign firms and Indian Government, or between foreign governments and Indian Government.

2. Bilateral Government Funding Arrangement: Generally, advanced countries provide aid in the form of loans and advances, grants, subsidies to governments of under-developed and developing countries. The aid is provided usually for financing government and public sector projects. Funds are provided at concessional terms in respect of cost (interest), maturity, and repayment schedule.

3. NRI Deposits and Investments: on-resident Indian have always been making a contribution in Indian economy. Government has been making efforts to encourage their deposits and investments. Various schemes have been devised which ensure higher returns; procedures have been simplified to attract investments in primary and secondary market. Tax incentives are given on interest earned and dividends received by NRIs.

4. Loans from International Financial Institutions : International Bank for Reconstruction and Development (IBRD), International Monetary Fund (IMF), Asian Development Bank (ADB),and World Bank have been the major source of external finance to India.

5. External Commercial Borrowing (CEB) : Our country has also been obtaining foreign capital in the form of external commercial borrowings from agencies like US EXIM Bank, ECGC of UK, etc.

## **7. Non Official Foreign Source of Finance:**

### **Foreign Direct Investment (FDI)**

Foreign direct investment is one of the most important sources of foreign investment in developing countries like India. It is seen as a means to supplement domestic investment for achieving a higher level of growth and development. FDI is permitted under the forms of investments.

1. Through financial collaborations / capital / equity participation;
2. Through Joint ventures and technical collaborations;
3. Through capital markets (Euro Issues);

4. Through private placements or preferential allotment.

Capital participation / financial collaboration refers to the foreign partner's stake in the capital of the receiving country's companies while technical collaboration refers to such facilities provided by foreign partner as licencing, trade marks and patents (against which he gets lump sum fee or royalty payments for specified period); technical services etc.

From investors' point of view, the FDI inflows can be classified into the following groups.

(a) Market seeking : The investors are attracted by the size of the local market, which depends on the income of the country and its growth rate.

(b) Lower cost : Investors are more cost-conscious. They are influenced by infrastructure facilities and labour costs.

(c) Location and other factors : Technological status of a country, brand name, goodwill enjoyed by the local firms, favourable location, openness of the economy, policies of the government and intellectual property protection granted by the government are some of the factors that attract investors to undertake investments.

#### **SHORT TERM FUNDS :**

Short term funds are usually required for working capital; to operate the project after it is completed. The working capital consists of the margin to be provided by the entrepreneur and the bulk of the balance is borrowed from a commercial bank or some other source as short term finance. The margin to be provided by the entrepreneur is included in the project cost estimates and is in financed from the various means of financing discussed earlier. The main sources of working capital are :-

1. Commercial banks,
2. The type of debentures issued for meeting working capital requirements are usually then on-convertible debentures.
3. Public Deposit
4. Commercial Paper
5. Supplier' Credit
6. Foreign currency funds etc.



**UNIT- V Leverages –Meaning and Significance – Types: Operating, Financial and Combined Leverages–Dividend Theories and Dividend Policies – Forms of Dividend.**

**LEVERAGE**

The concept of leverage has its origin in science. It means influence of one force over another. Since financial items are inter-related, change in one, causes change in profit. In the context of financial management, the term ‘leverage’ means sensitiveness of one financial variable to change in another. The measure of this sensitiveness is expressed as a ratio and is called degree of leverage. Algebraically, the leverage may be defined as, %Change in one variable

$$\text{Leverage} = \frac{\% \text{ Change in one variable}}{\% \text{ Change in some other variable}}$$

**CONCEPT AND NATURE OF LEVERAGES OPERATING RISK AND FINANCIAL RISK AND COMBINED LEVERAGE :**

The concept of leverage has its origin in science. It means influence of one force over another. Since financial items are inter-related, change in one, causes change in profit. In the context of financial management, the term ‘leverage’ means sensitiveness of one financial variable to change in another. The measure of this sensitiveness is expressed as a ratio and is called degree of leverage.

**Operating Leverage**

It is important to know how the operating leverage is measured, but equally essential is to understand its nature in financial analysis.

Operating leverage reflects the impact of change in sales on the level of operating profits of the firm.

The significance of DOL may be interpreted as follows :

- Other things remaining constant, higher the DOL, higher will be the change in EBIT for same change in number of units sold in, if firm A has higher DOL than firm B, profits of firm A will increase at faster rate than that of firm B for same increase in demand.

This however works both ways and so losses of firm A will increase at faster rate than that of firm B for same fall in demand. This means higher the DOL, more is the risk.

- DOL is high where contribution is high.

-There is an unique DOL for each level of output.

Operating Leverage examines the effect of the change in the quantity produced on the EBIT of the Company and is measured by calculating the degree of operating leverage (DOL)The degree of operating leverage is therefore ratio between proportionate change in EBIT and corresponding proportionate change in Q.

## **Financial Leverage**

The Financial leverage may be defined as a % increase in EPS associated with a given percentage increase in the level of EBIT. Financial leverage emerges as a result of fixed financial charge against the operating profits of the firm. The fixed financial charge appears in case the funds requirement of the firm is partly financed by the debt financing. By using this relatively cheaper source of finance, in the debt financing, the firm is able to magnify the effect of change in EBIT on the level of EPS. The significance of DFL may be interpreted as follows :

- Other things remaining constant, higher the DFL, higher will be the change in EPS for same change in EBIT. In other words, if firm K has higher DFL than firm L, EPS of firm k increases at faster rate than that of firm L for same increase in EBIT. However, EPS of firm

K falls at a faster rate than that of firm K for same fall in EBIT. This means, higher the DFL more is the risk.

- Higher the interest burden, higher is the DFL, which means more a firm borrows more is its risk.

- Since DFL depends on interest burden, it indicates risk inherent in a particular capital mix, and hence the name financial leverage.

There is an unique DFL for each amount of EBIT.

While operating leverage measures the change in the EBIT of a company to a particular change in the output, the financial leverage measures the effect of the change in EBIT on the EPS of the company.

Thus the degree of financial leverage (DFL) is ratio between proportionate change in EPS and proportionate change in EBIT.

## **Combined Leverage**

The operating leverage explains the business risk of the firm whereas the financial leverage deals with the financial risk of the firm. But a firm has to look into the overall risk or total risk of the firm, which is business risk plus the financial risk.

One can draw the following general conclusion about DCL.

- Other things remaining constant, higher the DCL, higher will be the change in EPS for same change in Q (Demand).

- Higher the DCL, more is the overall risk, and higher the fixed cost and interest burden lower is the earning after interest, and higher is the DCL.

- There is an unique DCL, for each level of Q.

A combination of the operating and financial leverages is the total or combination leverage.

The operating leverage causes a magnified effect of the change in sales level on the EBIT

level and if the financial leverage combined simultaneously, then the change in EBIT will, in turn, have a magnified effect on the EPS. A firm will have wide fluctuations in the EPS for even a small change in the sales level. Thus effect of change in sales level on the EPS is known as combined leverage.

Thus Degree of Combined leverage may be calculated as follows :

$$\text{DOL} = \frac{\text{Contribution}}{\text{EBIT}}$$

## **DIVIDEND DECISION**

The term dividend refers to that part of profits of a company which is distributed by the company among its shareholders. It is the reward of the shareholders for investments made by them in the shares of the company. The investors are interested in earning the maximum return on their investments and to maximize their wealth. A company, on the other hand, needs to provide funds to finance its long-term growth. If a company pays out as dividend most of what it earns, then for business requirements and further expansion it will have to depend upon outside resources such as issue of debt or new shares. Dividend policy of a firm, thus affects both the long-term financing and the wealth of shareholders.

## **DIVIDEND DECISION AND VALUATION OF FIRM :**

The value of the firm can be maximized if the shareholders wealth is maximized. There are conflicting views regarding the impact of dividend decision on the valuation of the firm. According to one school of thought dividend decision does not affect the share-holders' wealth and hence the valuation of the firm. On the other hand, according to the other school of thought, dividend decision materially affects the shareholders' wealth and also the valuation of the firm. We have discussed below the views of the two schools of thought under two groups :

### **a. The Relevance Concept of Dividend or the Theory of Relevance**

### **b. The Irrelevance Concept of Dividend or the Theory of Irrelevance maximized**

The Relevance Concept of Dividends: According to this school of thought, dividends are relevant and the amount of dividend affects the value of the firm. Walter, Gordon and others propounded that dividend decisions are relevant in influencing the value of the firm. Walter argues that the choices of dividend policies almost and always affect the value of the enterprise. The Irrelevance Concept of Dividend : The other school of thought propounded by Modigliani and Miller in 1961. According to MM approach, the dividend policy of a firm is irrelevant and it does

not affect the wealth of the shareholders. They argue that the value of the firm depends on the market price of the share; the dividend decision is of no use in determining the value of the firm.

#### **WALTER'S MODEL :**

Walter's model, one of the earlier theoretical models, clearly indicates that the choice of appropriate dividend policy always affects the value of the enterprise. Professor James E. Walter has very scholarly studied the significance of the relationship between the firm's internal rate of return,  $r$ , (or actual capitalization rate) and its Cost of Capital,  $K_e$  (normal capitalization rate) in determining such dividend policy as will maximize the wealth of the stockholders.

Walter's model is based on the following premises:

- (1) The firm finance its entire investments by means of retained earnings. New equity stock or debenture is not issued to raise funds.
- (2) Internal rate of return ( $r$ ) and cost of capital ( $K_e$ ) of the firm remain constant.
- (3) The firm's earnings are either distributed as dividends or reinvested internally.
- (4) Earnings and dividends of the firm never change.
- (5) The firm has long or infinite life.

It may be noted that Walter's formula has the same effect as the continuing dividend growth formula. It seeks to measure the effect of dividends on common stock value by comparing actual and normal capitalization rates.

Another feature of Walter's formula is that it provides an added or reduced Weight to the retained earnings portion of the capitalization earnings formula. The factors ' $r$ ' and ' $k$ ' are placed in front of retained earnings to change its weighted value under different situations as discussed below:

#### **1. Growth Firms**

In growth firms internal rate of return is greater than the normal rate ( $r > k$ ). Therefore,  $r/k$  factor will be greater than 1. Such firms must reinvest retained earnings since existing alternative investments offer a lower return than the firm is able to secure. Each rupee of retained earnings will have a higher weighting in Walter's formula than a comparable rupee of dividends. Thus, the larger the firm retains, the higher the value of the firm. Optimum dividend payout ratio for such a firm will be zero.

#### **2. Normal Firm**

Normal firms comprise those firms whose internal rate of return is equal to normal capitalization ( $r=k$ ). These firms earn on their investments a rate of return equal to market rate of return. For such firms dividend policy will have no effect on the market value per share in the Walter's model. Accordingly, retained earnings will have the same weighted value as dividends. In this case the market value per share is affected by the payout ratio.

### **3. Declining Firms**

Firms which earn on their investments less than the minimum rate required are designated as declining firms. The management of such firms would like to distribute its earnings to the stockholders so that they may either spend it or invest elsewhere to earn higher return than earned by the declining firms. Under such a situation each rupee of retained earnings will receive lower weight than dividends and market value of the firm will tend to be maximum when it does not retain earnings at all.

### **4. Evaluation of the Walter's Model**

Professor Walter has endeavoured to show in an erudite manner the effects of dividend policy on value of equity shares under different situations of a firm. However, the basic premises on which edifice of the theory are laid down are unrealistic and therefore, conclusions drawn from the Walter's model are hardly true for real life situations. Thus, for instance assume that a firm finances its investment opportunities only by means of internal sources and no external financing is resorted to for this purpose.

Further, Professor Walter has assumed that 'r' remains constant under all the situations. As a matter of fact, 'r' tends to decrease in correspondence with increase in level of investments. This is why it is suggested that the management should make investments upto optimal level where  $r = k$ .

Finally, assumption of constant cost of capital  $k$  is incorrect. On the contrary, it varies in tune with change in risk of the firm.

### **GORDON'S MODEL :**

Myron Gordon has also developed a model on the lines of Prof. Walter suggesting that dividends are relevant and the dividend decision of the firm affects its value. His basic valuation model is based on the following assumptions:

1. The firm is an all equity firm.
2. No external financing is available or used. Retained earnings represent the only source of financing investment programmes.
3. The rate of return on the firm's investment  $r$ , is constant.
4. The retention ratio,  $b$ , once decided upon is constant. Thus, the growth rate of the firm  $g = br$ , is also constant.
5. The cost of capital for the firm remains constant and it is greater than the growth rate, i.e.  $k > br$ .
6. The firm has perpetual life.
7. Corporate taxes do not exist.

According to Gordon, the market value of a share is equal to the present value of future stream of dividends. Thus,

### **MODIGLIANI-MILLER'S MODEL (M-M'S MODEL) :**

Modigliani-Miller's (M-M's) thoughts for irrelevance of dividends are most comprehensive and logical. According to them, dividend policy does not affect the value of a firm and is therefore, of no consequence. It is the earning potentiality and investment policy of the firm rather than its pattern of distribution of earnings that affects value of the firm.

#### **Basic Assumptions of M-M Approach**

- (1) There exists perfect capital market where all investors are rational. Information is available to all at no cost; there are no transaction costs and floatation costs. There is no such investor as could alone influence market value of shares.
- (2) There does not exist taxes. Alternatively, there is no tax differential between income on dividend and capital gains.
- (3) Firm has uncertainty as to future investments and profits of the firm. Thus, investors are able to predict future prices and dividend with certainty. This assumption is dropped by M-M later.

M-M's irrelevance approach is based on arbitrage argument. Arbitrage is the process of entering into such transactions simultaneously as exactly balance or completely offset each other. The two transactions in the present case are payment of dividends and garnering funds to exploit investment opportunities. Suppose, for example, a firm decides to invest in a project it has alternatives:

- (1) Pay out dividends and raise an equal amount of funds from the market;
- (2) Retain its entire earnings to finance the investment programme. The arbitrage process is involved where a firm decides to pay dividends and raise funds from outside.

#### **RESIDUAL MODEL:**

If a firm wishes to avoid issue of shares, then it will have to rely on internally generated funds to finance new positive NPV projects. Dividends can only be paid out of what is left over. This leftover is called a residual and such a dividend policy is called residual dividend approach.

When we treat dividend policy as strictly a **financing decision**, the payment of cash dividends is a passive residual. The amount of dividend payout will fluctuate from period to period in keeping with fluctuations in the number of acceptable investment opportunities available to the firm. If these opportunities abound, the percentage of dividend payout is likely to be zero. On the other hand if the firm is unable to find profitable investment opportunities, dividend payout will be

100%.

## **TYPES OF DIVIDENDS**

Dividends may be declared in the form of cash, stock, scrips, bonds and property.

### **1. Cash Dividends**

Cash dividend is, by far, the most important form of dividend. In cash dividends stock holders receive cheques for the amounts due to them. Cash generated by business earnings is used to pay cash dividends. Sometimes the firm may issue additional stock to use proceeds so derived to pay cash dividends or approach bank for the purpose. Generally, stockholders have strong preference for cash dividends.

### **2. Stock Dividends**

Stock dividends rank next to cash dividends in respect of their popularity. In this form of dividends, the firm issues additional shares of its own stock to the stockholders in proportion to the number of shares held in lieu of cash dividends. The payment of stock dividends neither affects cash and earnings position of the firm nor is ownership of stockholders changed. Indeed there will be transfer of the amount of dividend from surplus account to the capital stock account which tantamount to capitalization of retained earnings.

### **3. Stock Splits**

Closely related to a stock dividend is a stock split. From a purely economic point of view a stock split is nothing but a giant stock dividend. A stock split is a change in the number of outstanding shares of stock achieved through a proportional reduction of increase in the par value of the stock. The management employs this device to make a major adjustment in the market price of the firm's stock and consequently in its earnings and dividends per share.

### **3. Scrip Dividend**

Scrip dividend means payment of dividend in scrip or promissory notes. Sometimes company needs cash generated by business earnings to meet business requirements because of temporary shortage of cash. In such cases the company may issue scrip or notes promising to pay dividend at a future date. The scrip usually bears a definite date of maturity or sometimes maturity date is not stipulated and its payment is left to the discretion of the Board of Directors. Scrips may be interest-bearing or non-interest bearing. Such dividends are relatively scarce.

### **2. Bond Dividend**

As in scrip dividends, dividends are not paid immediately in bond dividends. Instead the company promises to pay dividends at a future date and to that effect bonds are issued to stock holders in place of cash. The purpose of both the bond and scrip dividends is alike, i.e., postponement of dividend payments..

### **(5)Property Dividends**

In property dividend the company pays dividends in the form of assets other than cash. Generally, assets which are superfluous for the company are distributed as dividends to the stockholders. Sometimes the company may use its products to pay dividends. Securities of the subsidiary companies owned by the company may also take the form of property dividends. This kind of dividend payment is not in vogue in India.

### **FACTORS AFFECTING DIVIDEND POLICY:**

There is a controversy amongst financial analysts regarding impact of dividends on market price of a company's shares. Some argue that dividends do not have any impact on such price while others hold a different opinion. However, preponderance of evidence suggests that dividend policies do have a significant effect on the value of the firm's equity shares in the stock exchange. Having accepted this premise, it will now be appropriate to consider those factors which affect the dividend policy of a firm.

The factors affecting the dividend policy are both external as well as internal.

#### **External factors**

**1) General state of economy** - The general state of economy affects to a great extent the management's decision to retain or distribute earnings of the firm. In case of uncertain economic and business conditions, the management may like to retain the whole or a part of the firm's earnings to build up reserves to absorb shocks in the future.

**2) Legal restrictions** - A firm may also be legally restricted from declaring and paying dividends. For example, in India, the companies Act, 1956 has put several restrictions regarding payments and declaration of dividends. Some of these restrictions are as follows :

- (i) Dividends can only be paid out of (a) the current profits of the company, (b) the past accumulated profits or (c) money provided by the Central or State Governments for the payment of dividends in pursuance of the guarantee given by the Government. Payment of dividend out of capital is illegal.
- (ii) A company is not entitled to pay dividends unless (a) it has provided for present as well as all arrears of depreciation, (b) a certain percentage of net profits of that year as prescribed by the central Government not exceeding 10%, has been transferred to the reserves of the company.
- (iii) Past accumulated profits can be used for declaration of dividends only as per the rules framed by the Central Government in this behalf.

Similarly, the Indian Income Tax Act also lays down certain restrictions on payment of



dividends. The management has to take into consideration all the legal restrictions before taking the dividend decision otherwise it may be declared as ultra vires .

### **Internal factors**

The following are the internal factors which affect the dividend policy of a firm:

1. Desire of the shareholders - Of course, the directors have considerable liberty regarding the disposal of the firm's earnings, but the shareholders are technically the owners of the company and, therefore, their desire cannot be overlooked by the directors while deciding about the dividend policy.

Shareholders of a firm expect two forms of return from their investment in a firm:

(i) Capital gains - The shareholders expect an increase in the market value of the equity shares held by them over a period of time. Capital gain refers to the profit resulting from the sale of capital investment i.e., the equity shares in case of shareholders. For example, if a shareholder purchases a share for 40 and later on sells it for 60 the amount of capital gain is a sum of 20.

(ii) Dividends - The shareholders also expect a regular return on their investment from the firm. In most cases the shareholders' desire to get dividends takes priority over the desire to earn capital gains because of the following reasons:

(a) Reduction of uncertainty - Capital gains or a future distribution of earnings involves more uncertainty than a distribution of current earnings.

(b) Indication of strength - The declaration and payment of cash dividend carries an information content that the firm is reasonably strong and healthy.

(c) Need for current income - Many shareholders require income from the investment to pay for their current living expenses. Such shareholders are generally reluctant to sell their shares to earn capital gain.

2. **Financial needs of the company** - The financial needs of the company are to be considered by the management while taking the dividend decision. Of course, the financial needs of the company may be in direct conflict with the desire of the shareholders to receive large dividends..

3. **Desire of control** - Dividend policy is also influenced by the desire of shareholders or the management to retain control over the company. The issue of additional equity shares for procuring funds dilutes control to the detriment of the existing equity shareholders who have a dominating voice in the company. At the same time, recourse to long-term loans may entail financial risks and may prove disastrous to the interests of the shareholders in times of financial difficulties.

4. **Liquidity position** - The payment of dividends results in cash outflow from the firm. A firm may have adequate earnings but it may not have sufficient cash to pay dividends. It is, therefore, important for the management to take into account the cash position and the overall liquidity

position of the firm before and after payment of dividends while taking the dividend decision.

## **TYPES OF DIVIDEND POLICY :**

The various types of dividend policies are discussed as follows:

### **1. Regular Dividend Policy**

Payment of dividend at the usual rate is termed as regular dividend. The investors such as retired persons, widows and other economically weaker persons prefer to get regular dividends.

A regular dividend policy offers the following advantages.

- a. It establishes a profitable record of the company.
- b. It creates confidence amongst the shareholders.
- c. It aids in long-term financing and renders financing easier.
- d. It stabilizes the market value of shares.
- e. The ordinary shareholders view dividends as a source of funds to meet their day-today living expenses.
- f. If profits are not distributed regularly and are retained, the shareholders may have to pay a higher rate of tax in the year when accumulated profits are distributed.

However, it must be remembered that regular dividends can be maintained only by companies of long standing and stable earnings. A company should establish the regular dividend at a lower rate as compared to the average earnings of the company.

### **2. Stable Dividend Policy**

The term 'stability of dividends' means consistency or lack of variability in the stream of dividend payments. In more precise terms, it means payment of certain minimum amount of dividend regularly. A stable dividend policy may be established in any of the following three forms.

Constant dividend per share: Some companies follow a policy of paying fixed dividend per share irrespective of the level of earnings year after year. Such firms, usually, create a 'Reserve for Dividend Equalisation' to enable them to pay the fixed dividend even in the year when the earnings are not sufficient or when there are losses. A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over a number of years. Figure given below shows the behaviour of dividend in such policy.

### **2. Irregular Dividend Policy**

Some companies follow irregular dividend payments on account of the following:

- a. Uncertainty of earnings.
- b. Unsuccessful business operations.

c. Lack of liquid resources.

d. Fear of adverse effects of regular dividends on the financial standing of the company.

#### 4. No Dividend Policy

A company may follow a policy of paying no dividends presently because of its unfavourable working capital position or on account of requirements of funds for future expansion and growth.

#### **5. Residual Dividend Policy**

When new equity is raised floatation costs are involved. This makes new equity costlier than retained earnings. Under the Residual approach, dividends are paid out of profits after making provision for money required to meet upcoming capital expenditure commitments.