

Financial Management

UNIT-I

Meaning

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.

Definition

Howard and Upton: Financial management “as an application of general managerial principles to the area of financial decision-making.

Weston and Brigham: Financial management “is an area of financial decision-making, harmonizing individual motives and enterprise goals”.

Nature of Financial Management

1. Financial Management is an integral part of overall management. Financial considerations are involved in all business decisions so financial management is pervasive throughout the organisation.
2. In most of the organizations, financial operations are centralized. This results in economies.
3. Financial management involves with data analysis for use in decision making.
4. The central focus of financial management is valuation of the firm. That is financial decisions are directed at increasing/maximization/ optimizing the value of the firm.
5. Financial management essentially involves risk-return trade-off Decisions on investment involve choosing of types of assets which generate returns accompanied by risks. Generally higher the risk returns might be higher and vice versa. So, the financial manager has to decide the level of risk the firm can assume and satisfy with the accompanying return.
6. Financial management affects the survival, growth and vitality of the firm. Finance is said to be the life blood of business. It is to business, what blood is to us. The amount, type, sources, conditions and cost of finance squarely influence the functioning of the unit.

7. Finance functions, i.e., investment, rising of capital, distribution of profit, are performed in all firms - business or non-business, big or small, proprietary or corporate undertakings.

8. Financial management is a sub-system of the business system which has other subsystems like production, marketing, etc. In systems arrangement financial sub-system is to be well-coordinated with others and other sub-systems.

Objectives of Financial Management

1. Profit maximization

It is commonly believed that a shareholders objective is to maximise profit. To achieve the goal of profit maximisation, the financial manager takes only those actions that are expected to make a major contribution to the firm's overall profits. The total earnings available for the firm's shareholders is commonly measured in terms of earnings per share (EPS). Hence the decisions and actions of finance managers should result in higher earnings per share for shareholders.

Points in favour of profit maximisation:

- It is a parameter to measure the performance of a business
- It ensures maximum welfare to the shareholders, employees and prompt payment to the creditors
- Increase the confidence of management in expansion and diversification.
- It indicates the efficient use of funds for different requirements.

Points against profit maximisation:

- It is not a clear term like accounting profit, before tax or after tax or net profit or gross profit.
- It encourage corrupt practices
- It does not consider the element of risk
- Time value of money is not reflected
- Attracts cut –throat competition
- Huge profits attracts government intervention
- It invites problem from workers.

- It affects the long run liquidity of a company.

2. Wealth Maximisation

The goal of the finance function is to maximise the wealth of the owners for whom the firm is being carried on. The wealth of corporate owners is measured by the share price of the stock, which in turn, is based on the timing of return, cash flows and risk. While taking decisions, only that action that is expected to increase share price should be taken.

It considers:

- (a) Time value of money on investment decision
- (b) The risk or uncertainty of future earnings and
- (c) Effects of dividend policy on the market price of shares.

Points In favour of Wealth Maximisation

- It is a clear term
- Net effect of investment and benefits can be measured clearly.
- It considers the time value for money.
- It should be accepted universally
- It guides the management in framing a consistent strong dividend policy to reach maximum return to the equity holders

Points against wealth maximisation:

- This concept is useful for equity share holders not for debenture holders
- The expectations of workers, consumers and various interest groups create a greater influence that must be respected to achieve long run wealth maximization and also for their survival.

Functions of Finance manager

1. Forecasting Financial Requirements

It is the primary function of the Finance Manager. He is responsible to estimate the financial requirement of the business concern. He should estimate, how much finances required to acquire fixed assets and forecast the amount needed to meet the working capital requirements in future.

2. Acquiring Necessary Capital

After deciding the financial requirement, the finance manager should concentrate how the finance is mobilized and where it will be available. It is also highly critical in nature.

3. Investment Decision

The financemanager must carefully select best investment alternatives and consider the reasonable and stable return from the investment. He must be well versed in the field of capital budgeting techniques to determine the effective utilization of investment. The finance manager must concentrate to principles of safety, liquidity and profitability while investing capital.

4. Cash Management

Present day's cash management plays a major role in the area of finance because proper cash management is not only essential for effective utilization of cash but it also helps to meet the short-term liquidity position of the concern.

5. Interrelation with Other Departments

Finance manager deals with various functional departments such as marketing, production, personnel, system, research, development, etc. Finance manager should have sound knowledge not only in finance related area but also well versed in other areas. He must maintain a good relationship with all the functional departments of the business organization

UNIT-II

Cost of Capital

Meaning of Cost of Capital

Cost of capital is the return expected by the providers of capital (i.e. shareholders, lenders and the debt-holders) to the business as a compensation for their contribution to the total capital. Cost of capital is also known as 'cut-off' rate, 'hurdle rate', 'minimum rate of return' etc. .

Significance of the Cost of Capital

Evaluation of investment options:

The estimated benefits (future cash flows) from available investment opportunities (business or project) are converted into the present value of benefits by discounting them with the relevant cost of capital.

Financing Decision:

When a finance manager has to choose one of the two sources of finance, he can simply compare their cost and choose the source which has lower cost. Besides cost he also considers financial risk and control

Designing of optimum credit policy:

While appraising the credit period to be allowed to the customers, the cost of allowing credit period is compared against the benefit/ profit earned by providing credit to customer of segment of customers

Measurement of Specific Cost of Different Sources:

I. Cost of Debt: (K_d)

The cost of debt is defined in terms of the required rate of return that the debt investment must yield to protect the shareholders interest.

Cost of Irredeemable Debentures Before Tax – Issued at Par, Premium or Discount
$K_i = I/NP \times 100$
Cost of Irredeemable Debentures After Tax – Issued at Par, Premium or Discount
$K_d = I/NP \times 100(1-t) \text{ or } K_d = r (1-t)$
Cost of Redeemable Debentures Before Tax – Issued at Par, Premium or Discount
$K_i = \frac{I + \frac{1}{n} (P-NP)}{1/2(P + NP)}$
Cost of Redeemable Debentures After Tax – Issued at Par, Premium or Discount
$K_d = \frac{[I + \frac{1}{n} (P-NP)] \times (1-t)}{1/2(P + NP)}$

I = Interest

NP = Net Proceeds

n = Number of years for maturity

P = Redeemable value of debentures

II. Cost of Preference Shares (K_p):

Cost of preference shares are the fixed cost bearing securities. The dividend rate is fixed well in advance at the time of their issue

Irredeemable Preference Shares	$K_p = D/NP$
Redeemable Preference Shares	$K_p = \frac{D + 1/n (P-NP)}{\frac{1}{2}(P+NP)}$

D = Dividend for preference share holder

NP = Net Proceeds per share = Face value + Premium – Discount – Cost of issue (if any)

n = Number of years for maturity

P = Redeemable value of Preference shares

III. Cost of Equity Shares (K_e):

The cost of equity capital is the minimum rate of return that the firm must earn on the equity financed portion of an investment project in order to leave unchanged the market price of the stock.

(a) Dividend / Price Approach:

According to this approach the value of an equity share is equivalent to the present value of future dividends plus the present value of the price expected to be realized.

$K_e = D/NP$ or D/MP

D = Dividend Per share

NP = Net Proceeds per share = Face value + Premium – Discount – Cost of issue (if any)
MP = Market Price Per Share

(b) Dividend / Price + growth rate Approach:

This approach takes into account dividend as well as rate of growth in the dividend, which is assumed to be equal to the growth rate in earnings per share and market price per share.

$K_e = D/NP + G$

D = Dividend Per share

NP = Net Proceeds per share = Face value + Premium – Discount – Cost of issue (if any)

MP = Market Price Per Share

G = Growth Rate of Dividends

(c) Earnings Price ratio Approach:

This ratio establishes the relationship between earnings and market price of the shares.

Shareholders capitalize a stream of unchanged earnings by the capitalization ratio of E / P in order to evaluate their holdings.

$K_e = E / NP$ or MP

NP = Net Proceeds per share = Face value + Premium – Discount – Cost of issue (if any)

MP = Market Price Per Share

E = Earnings Per Share

(d) Realised Yield Approach:

This approach is based on the rate of return actually realized for a period of time by investors in a company. Under this approach, the realized yield is discounted at the present value factor and then compared with the value of investment.

$K_e = E / NP$ or MP

IV. Cost of Retained Earnings:

Retained earnings also have opportunity cost. Opportunity cost of retained earnings is other rate of return which they can get by investing the after tax dividends in other alternative opportunities. It can be expressed as:

$K_r = K_e (1 - T) (1 - B)$

T = tax rate

B = Brokerage rate

Weighted Average Cost of Capital

Weighted average is an average of the costs of specific sources of capital employed in a business, properly weighted by the proportion, they hold in the firm's capital structure.

Book Value Weights and Market Value Weights:

The weighted cost of capital can be computed by using the book value or the market value weights. Book value weight will be understated if the market value of the share is higher than the book value and vice-versa.

Steps involved in computation of WACC

• Calculate the cost of each of the sources of finance is ascertained. • Assigning weights to specific costs. • Multiplying the cost of each source by the appropriate weights. • Dividing the total weighted cost by the total weights.

Capital Budgeting

The term capital budgeting or investment decision means planning for capital assets. Capital budgeting decision means the decision as to whether or not to invest in long-term projects such as setting up of a factory or installing a machinery etc. It includes the financial analysis of the various proposals regarding capital expenditure to evaluate their impact on the financial condition of the company for the purpose to choose the best out of the various alternatives.

Importance of Capital Budgeting

i) Permanent commitment of funds

The funds capital expenditure projects are not only huge but more or less permanently blocked These are long term decision .The longer the time the greater the risk is involved Hence careful planning is essential

ii) Irreversible in nature

In most cases, capital budgeting decision are irreversible .once the decision for acquiring a permanent assets is taken ,it is very difficult to reverse the decision .This is because it is difficult to dispose the assets without incurring heavy losses.

iii)Growth and Expansion

Business firm grow, expand, diversify and acquire stature in the industry through their capital budgeting activities. The success of mobilization and deployment of funds determines .the future of a firm

iv)Multiplicity of variables

Large number of factors affect the decision on capital expenditure ,They make the capital expenditure decision the most difficult to make

v)Top management activity

The net result of capital expenditure' decisions automatically trusts them on the top management. Only senior managerial personnel can take these decisions and bear responsibility for them.

Capital Budgeting Techniques

I. Traditional methods:

- Pay-Back Period Method:
- Accounting Or Average Rate Of Return

A) Pay-Back Period Method:

It is the most popular and widely recognized traditional method of evaluating the investment proposals. It can be defined, as „the number of years required to recover the original cash out lay invested in a project“. “The payback period is the number of years required to recover initial cash investment.

$$\text{Payback Period} = \frac{\text{Initial Investment or Original Cost of the Asset}}{\text{Cash Inflows}}$$

B) Accounting Or Average Rate Of Return Accounting Rate of Return (ARR) is the average net income an asset is expected to generate divided by its average capital cost, expressed as an annual percentage.. This method called accounting rate of return method because it fees the accounting concept of profit. i.e. income after depreciation and tax as the criterion for calculation of return.

Accounting Rate of return (on Original Investment)

$$\text{ARR} = \text{Average Annual Profit} / \text{Initial Investment}$$

Accounting Rate of return (on Average Investment)

$$\text{ARR} = \text{Average Annual Profit} / \text{Average Investment}$$

II: Discounted cash flow methods:

- Net present value method
- Profitability Index method
- Internal rate of return method
- Modified Internal rate of return method

A) Net Present Value Method:

The NPV takes into consideration the time value of money. The cash flows of different years and valued differently and made comparable in terms of present values for this the net cash inflows of various period are discounted using required rate of return which is predetermined.

$$\text{NPV} = \sum \frac{CF_n}{(1+i)^n} - \text{Initial Investment}$$

B) Profitability Index Method:

Profitability Index (PI) or Benefit-cost ratio (B/C) is similar to the NPV approach. PI approach measures the present value of returns per rupee invested. It is observed in shortcoming of NPV that, being an absolute measure, it is not a reliable method to evaluate projects requiring different initial investments. The PI method provides solution to this kind of problem.

$$\text{Profitability Index} = \frac{\text{Present Value of Cash Inflows}}{\text{Present Value of Cash Outflows}}$$

Using the PI ratio, Accept the project when $PI > 1$ Reject the project when $PI < 1$

C) Internal Rate of Return Method:

The IRR for an investment proposal is that discount rate which equates the present value of cash inflows with the present value of cash out flows of an investment. The IRR is also known as cut off or handle rate. It is usually the concern's cost of capital.

value becomes Zero. As this discount rate is determined internally, this method is called internal rate of return method.

$$\text{IRR} = r_a + \frac{\text{NPV}_a}{\text{NPV}_a - \text{NPV}_b} (r_b - r_a)$$

r_a = lower discount rate chosen
 r_b = higher discount rate chosen
 N_a = NPV at r_a
 N_b = NPV at r_b

D) Modified Internal Rate of Return Method:

The modified internal rate of return (MIRR) is the return on an investment, considering not only the cash flows of the investment, but the earnings on these cash flows based on a specific reinvestment rate. Modified internal rate of return (MIRR) is a capital budgeting tool which allows project cash flows to grow at a rate different than the internal rate of return

Calculating the MIRR considers three key variables:

- (1) The future value of cash inflows discounted at the reinvestment rate
- (2) The present value of cash outflows discounted at the financing rate

(3) The number of periods.

$$\text{MIRR} = \sqrt[n]{\frac{\text{FVCF}}{\text{PVCF}}} - 1$$

Where:

- FVCF – the future value of positive cash flows discounted at the reinvestment rate
- PVCF – the present value of negative cash flows discounted at the financing rate
- n – The number of periods

UNIT-III

Leverage

Meaning:

Leverage is an investment strategy of using borrowed money—specifically, the use of various financial instruments or borrowed capital—to increase the potential return of an investment.

Definitions Leverage:

According to Ezra Solomon:

“Leverage is the ratio of net returns on shareholders equity and the net rate of return on capitalisation”.

According to J. C. Van Home:

“Leverage is the employment of an asset or funds for which the firm pays a fixed cost of fixed return.”

Types of Leverage:

- (i) Operating leverage
- (ii) Financial leverage
- (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.

Degree of Operating Leverage:

The earnings before interest and taxes (i.e., EBIT) changes with increase or decrease in the sales volume. Operating leverage is used to measure the effect of variation in sales volume on the level of EBIT.

The formula used to compute operating leverage is:

$$\text{Operating Leverage} = \frac{\% \text{ change in EBIT}}{\% \text{ change in sales}} = \frac{\frac{\text{Increase in EBIT}}{\text{EBIT}}}{\frac{\text{Increase in sales}}{\text{Sales}}}$$

The operating leverage at any volume of sales is defined as its degree. The degree of operating leverage is computed by dividing contribution by EBIT.

$$\text{Degree of operating leverage} = \frac{\text{Contribution}}{\text{EBIT}}$$

Here, contribution = Sales - Variable cost
 EBIT = Sales - Variable cost - Fixed cost

2. Financial Leverage:

Financial leverage is primarily concerned with the financial activities which involve rising 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.

Degree of Financing Leverage:

Financing leverage is a measure of changes in operating profit or EBIT on the levels of earning per share.

It is computed as:

- Financial leverage = Percentage change in EPS / Percentage change in EBIT = Increase in EPS / EPS / Increase in EBIT/EBIT
- The financial leverage at any level of EBIT is called its degree. It is computed as ratio of EBIT to the profit before tax (EBT).

- Degree of Financial leverage (DFL) = EBIT / EBT
- The value of degree of financial leverage must be greater than 1. If the value of degree of financial leverage is 1, then there will be no financial leverage.

3. 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.

The combined leverage can be measured with the help of the following formula:

Combined Leverage = Operating leverage x Financial leverage

$$= \frac{\% \text{ Change in EBIT}}{\% \text{ Change in sales}} \times \frac{\% \text{ Change in EPS}}{\% \text{ Change in EBIT}} = \frac{\% \text{ Change in EPS}}{\% \text{ Change in sales}}$$

The degree of combined leverage is measured by using the following formula :

$$\text{Degree of Combined Leverage (DCL)} = \text{DOL} \times \text{DFL}$$

$$= \frac{\% \text{ Change in EBIT}}{\% \text{ Change in sales}} \times \frac{\% \text{ Change in EPS}}{\% \text{ Change in EBIT}} = \frac{\% \text{ Change in EPS}}{\% \text{ Change in sales}}$$

If a firm has both the leverages at a high level, it will be very risky proposition. Therefore, if a firm has a high degree of operating leverage the financial leverage should be kept low as proper balancing between the two leverages is essential in order to keep the risk profile within a reasonable limit and maximum return to shareholders.

CAPITAL STRUCTURE

Capital Structure

Capital structure 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.

Factors Determining Capital Structure

1. Trading on Equity- The word —equity denotes the ownership of the company.

Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares.

2. Degree of control- In a company, it is the directors who are so called elected representatives of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights. If the company's management policies are such that they want to retain their voting rights in their hands, the capital structure consists of debenture holders and loans rather than equity shares.

3. Flexibility of financial plan- In an enterprise, the capital structure should be such that there is both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plans. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.

4. Choice of investors- The company's policy generally is to have different categories of investors for securities. Therefore, a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors.

5. Capital market condition- In the lifetime of the company, the market price of the shares has got an important influence. During the depression period, the company's capital structure generally consists of debentures and loans. While in period of boons and inflation, the company's capital should consist of share capital generally equity shares.

6. Period of financing- When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.

7. Cost of financing- In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits.

8. Stability of sales- In a company, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases.

9. Sizes of a company- Small size business firms capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.

UNIT-IV

Working Capital Management

Concepts of Working Capital:

Gross concept:

Gross (concept) working capital is the amount of funds invested in the various components of current assets. Current assets includes cash in hand, cash at bank, short term investments, debtors, bills receivable , stock of raw materials, work in progress, stock of finished goods, prepaid expenses and advance payment of expenses and other assets which are converted in to cash within one year.)

Net concept:

Net working capital refers to the excess of current assets over its current liabilities. Current liabilities are those liabilities, which are expected to mature for payment within an accounting year. A current liability includes creditors, bills payable, outstanding expenses and income received in advance.

Problems of inadequate working capital

1. Purchase of Raw Materials
2. Credit Rating
3. Seizing Business Opportunity
4. Duration of Operating Cycle
5. Maintenance of plant and machinery
6. Higher Interest
7. Low Return on Investment (ROI)

8. Liquidity verses profitability

9. Dividend policy

Dangers of Excessive Working capital:

Excessive working capital raises the following problems:

1. A Company may be tempted to overtrade and lose heavily.
2. A Company may keep very big inventories and tie up its funds unnecessarily.
3. There may be an imbalance between liquidity and profitability.
4. A Company may enjoy high liquidity and, at the same time, suffer from low profitability.
5. High liquidity may induce a company to undertake greater production, which may not have a matching demand.
6. A Company may invest heavily in its fixed equipment, which may not be justified by actual sales or production. This may result in over-capitalization.
7. Large volume of funds not being used productively.
8. The availability of excess working capital may lead to carelessness about costs and therefore, to inefficiency of operations.

Determinants of Working Capital

1. Nature of business
2. Size of the business
3. Operating cycle
4. Production policy
5. Turnover of Working capital
6. Credit Terms
7. Growth and Expansion
8. Price level changes
9. Operating efficiency

1. Nature of business

The working capital requirements of an organization are basically influenced by the nature of its business. The public utility service organisations require more fixed assets rather than working capital because they have cash sales only and they supply only services and not products. Thus, the amounts tied up with stock and debtors are almost zero. Generally, manufacturing business needs, more fixed assets rather than working capital. Further, the working capital requirements also depend on the seasonal products.

2. Size of the business

Another important factor is the size of the business. Size of the business means scale of operation. If the operation is on a large scale, it will need more working capital than a firm that has a small-scale operation.

3. Operating cycle

The term “production cycle” or “manufacturing cycle” refers to the time involvement from cash to purchase of raw materials and completion of finished goods and receipt of cash from sales. If the operating cycle requires a longer time span between cash to cash, the requirement of working capital will be more because of larger tie up of funds in all the processes

4. Production policy

The requirements of working capital are also determined by production policy. When the demand for the product is seasonal, inventory must be accumulated during the off-season period and this leads to more cost and risks. These firms, which manufacture variety of goods, will have advantages of keeping low working capital by adjusting the production according to season.

5. Turnover of Working capital

The speed of working capital is also influenced by the requirements of working capital. If the turnover is high, the requirement of working capital is low and vice versa.

6. Credit Terms

The level of working capital is also determined by credit terms, which is granted to customers as well as available from its creditors. More credit period allowed to debtors will result in high book debts, which leads to high working capital and more bad debts. On the other hand liberal credit terms available from creditors will lead to less working capital.

7. Growth and Expansion

As a company grows and expands logically, it requires a larger amount of working capital. Other things remaining same, growing industries need more working capital than those that are static.

8. Price level changes

Rising prices would necessitate the organization to have more funds for maintaining the same level of activities. Raising the prices in material, labour and expenses without proportionate changes in selling price will require more working capital. When a company raises its selling prices proportionally there will be no serious problem in the working capital.

9. Operating efficiency

Though the company cannot control the rising price in material, labour and expenses, it can make use of the assets at a maximum utilisation with reduced wastage and better coordination so that the requirement of working capital is minimised.

10. Other factors

Level of taxes: In this respect the management has no option. If the government increases the tax liability very often, taxes have to be paid in advance on the basis of the profit on the current year and this will need more working capital.

UNIT-IV

DIVIDEND

Definition

"Dividend may be defined as the return that a shareholder gets from the company, out of its profits, on his shareholdings." In other words, dividend is that part of the net earnings of a corporation that is distributed to its stockholders. It is a payment made to the equity shareholders for their investment in the company.

Types of dividend policy

a) Regular dividend policy:

In this type of dividend policy the investors get dividend at usual rate. Here the investors are generally retired persons or weaker section of the society who want to get regular income. This type of dividend payment can be maintained only if the company has regular earning.

b) Stable dividend policy/ stability of dividends:

Here the payment of certain sum of money is regularly paid to the shareholders.

c) Irregular dividend policy:

as the name suggests here the company does not pay regular dividend to the shareholders.

d) Zero dividend policy

All surplus earnings are invested back into the business. Such a policy is common during the

Growth phase. It should be reflected in increased share price.

Forms of Dividends

1) Cash Dividend:-

The dividend is paid in the cash. Adequate cash resources are required to pay in form of cash dividend most popular.

2) Property Dividend:-

In such a case it is paid in the form of assets other than cash generally company's products are distributed as dividends. This is not popular in India.

3) Stock Dividend:-

This is next to cash dividend in popularity. The company issues its own shares to share holders in addition to cash dividends. This is popularly known as Issue of bonus shares.

4) Bond Dividend:-

In case the company does not have sufficient funds to pay it pays dividend in the form of bonds. The bond holders get regular interest on their bonds as well as bond money on due date. Not popular in India.

Dividend Theories:-

It attempts to explain the (Relationship between the dividends and market value of the firm According to one school of thought Dividend Decision does not affect the share holders wealth and value of firm [irrelevance concept of dividend]

➤ Modigliani Miller's approach:

According to another school of thought Dividend decision affects the value of the firm and share holders' wealth [relevance concept of dividend]

➤ Walter's approach

➤ Gordon's approach

I .Relevance Concept of Dividend

A) Walter's Model:

Prof James. E Walter strongly supports the doctrine that the dividend decision affects the value of the firm According to Prof. James E. Walter, in the long run, share prices reflect the present value of future+ dividends. According to him investment policy and dividend policy are inter related and the choice of a appropriate dividend policy affects the value of an enterprise.

Statement:

Changes in dividend will affect the value of the firm. The Walter's model is based on relationship between (internal rate of return)

- **If $r > k$:** The firm can earn higher profits than what a share holders can earn from their investment. Such firms are termed as growth firms.

Optimum Dividend policy: Plough back the entire earnings

Dividend payment ratio=0

Entire amount is kept as retained earnings no dividends

- **If $r < k$:** The firm earns a lower profit than what the share holders can earn from their investment they are termed as declining firm.

Optimum dividend policy: To distribute entire earning as dividend.

Dividend payment ratio: 100% Entire earnings is distributed as dividend no retained earnings

- **If $r = k$:** The firm earnings is equal to the expectations of the share holders they are termed as normal firm

Optimum dividend policy: No optimum dividend policy. It does not matter whether the firm retains or distribute.

Assumptions: of the firm will not go for external finance such as debt or fresh issue of shares. It does the entire finance through retained earnings. o The rate of return (r) and cost of capital (k) remains constant. o The dividend declared by the firm and earnings per share remains constant. o The firm has a very long life.

Mathematical formula:

P_0 = Market value of the share

$P_0 = D + r (Eps - D)$

$$\frac{\quad}{k}$$

$$K$$

Where D = Dividend per share.

R = Rate of return

K = Cost of capital

E = Earnings per share

Criticism: Walter's model has subject to various criticisms many of its assumptions are unrealistic.

- ❖ Walter's assumption that financial requirements of a firm are met only by retained earnings is seldom true in real world situations. Firms do raise funds by debentures, eq.sha whenever they are in need of money.

- ❖ R may not constant:- The firm tend to choose more profitable projects, hence in real life r also changes.
- ❖ Similarly k may also not remain constant. The cost of capital may vary based on market conditions
- ❖ The firm may not have a perpetual life .The firm may wind up due to external and internal reasons.

B) **Gordons Model:** The value of a share, like any other financial asset, is the present value of the future cash flows associated with ownership. On this view, the value of the share is calculated as the present value of an infinite stream of dividends. Myron Gordon's Dividend Growth Model explains how dividend policy of a firm is a basis of establishing share value. Gordon's model uses the dividend capitalization approach for stock valuation. Myron Gordon relates the market value of the firm to the dividend policy.

Assumptions:

- No external financing:- The firm does not go for external financing.
- Constant return:- Rate of return(R) remains constant.
- Constant cost of capital:- K remains constant.
- Perpetual firm:- The firm has perpetual life.
- The firm is an all equity firm & it has no debt.
- No taxes:- Corporate taxes do not exist.
- Constant retention:- The retention ratio once decided remains constant. Thus growth rate is constant forever.
- Cost of capital is greater than growth rate $K > br=g$.

K = cost of capital

g = growth rate

Statement:

According to this model change in dividend will affect the value of the firm.

Value of firm

$$P_0 = \frac{E(1-b)}{k-g}$$

k-g

Where P_0 is market price of the share.

E = earnings per share.

b = retention ratio.

g = growth rate ($g=b*r$).

k = cost of capital. r = rate of return.

There are 3 kinds of firm

- Growth firm ($r > k$).
- Normal firm ($r = k$).
- Declining firm ($k < r$).

Criticism:

- Firms may raise funds by external sources also.
- R may not be constant always.
- K may not be constant always.
- Firm might not have perpetual life.
- Growth in dividend is not constant.
- Meaningful value is obtained when $k > g$. In other situations value of firm cannot be calculated.

Revised Gordon's Model

The bird in the hand augments: Gordon concludes that in a normal firm where $r=k$. Dividend policy does not affect value of shares. But in revised model Gordon states that dividend will affect the value of the firm even in normal firm. Investors behaving rationally are risk averse Prefer easily dividend which are certain than the rate dividends which are uncertain hence the investors prefer to avoid uncertainty and willing to pay higher price for the shares which gives greater current dividend other things held constant.

To conclude Gordon: A normal firm ($r=k$) must also payout dividends to get a higher market price.

II. Irrelevance Concept of Dividend C) Modigliani and Miller Approach (Mm Approach):

Modigliani and miller state that the price of shares of a firm is determined by its earning capacity and investment decision and never by its dividend decision. According to the MM hypothesis, market value of a share before dividend is declared is equal to the present value of dividends paid plus the market value of the share after dividend is declared.

1.3.1 Assumptions:

- Capital markets are perfect.
- Investors behave rationally.
- There is no flotation or transaction costs.
- There are either no taxes or no difference between tax rates applicable to capital gains or dividends.
- Information is freely available to investors.
- The firm has a fixed investment policy.
- Risk or uncertainty does not exist. Investors are able to forecast future prices and dividends with certainty.
- Shares are infinitely divisible.

Statement:-

Payment of dividends will not affect the value of shares.

Formulae:-

$$1) P_0 = \frac{D_1 + P_1}{1 + K_e}$$

$$2) P_1 = P_0 (1 + K_e) - D_1$$

3) No of shares to be issued

$$n P_1 = I - (e - n D_1)$$

Where E = earnings, $n D_1$ = Dividend X no. of shares, I = investment

4) Value of firm

$$n P_0 = P_1 (n + n) - I + E$$

$$1 + K_e$$

$$P_0 = \frac{D_1 + P_1}{1 + K_e}$$

$$1 + K_e$$

Where P_0 :- Prevailing market value of share

D_1 :- Dividend after one year

P_1 :- market value of share after one year

K_e :- Cost of capital $P_1 = P_0 (1 + K_e) - D_1$ Computation of no. of shares to be issued

$$m * P_1 = I - (X - n D_1)$$

m :- no of shares to be issued

P_1 :- Price at which new shares to be made

I:- amount of investment required

X:- Total net profit of the firm during the period

nD1:- Total dividends paid during the period after problems

Criticism:-

1) Perfect capital market does not exist for the following reasons.

- All investors are not logical while making investment.
- Shares are not infinitely divisible (they are available in market lots).
- Transaction cost exists.
- Flotation cost exists.
- Financial institutions are able to influence market decisions and investors buy & sell when FI's buy and sell.
- All investors do not get perfect information. FI's get better information compared to individual investors.
- Taxation Exists: Different rates of taxes on capital gains and dividend. Capital gains are charged at a lower rate than dividend.

2) The investment policy of the firm changes due to changes in return costs and market conditions.

3) Business risk of the firm will change because of changes in investment policies.

Short Answer Questions

1. Explain the term 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.

2. What are the functions performed by Financial Managers?

- ✓ Forecasting financial requirements
- ✓ Acquiring necessary capital
- ✓ Investment decision
- ✓ Cash management
- ✓ Interrelation with other departments

3. Explain any five factors determining Capital Structure,

1. Trading on Equity
2. Degree of control
3. Flexibility of financial plan
4. Choice of investors
5. Capital market condition

4. State the importance of Cost of Capital.

- Evaluation of investment options
- Financing Decision
- Designing of optimum credit policy

5. Write short note on Cost of Debt.

The cost of debt is defined in terms of the required rate of return that the debt investment must yield to protect the shareholders interest.

6. What are the importances of Capital Budgeting?

1. Permanent commitment of funds
2. Irreversible in nature
3. Growth and Expansion
4. Multiplicity of variables
5. Top management activity

7. What is meant by Financial Leverage?

Financial leverage refers to the use of funds obtained by fixed cost or fixed return securities (preference and debentures) in the hope of increasing the return to equity shareholders. It may be defined as % return on equity to the percentage on capitalization. Financial leverage may be defined as the firm's ability to use fixed financial costs to magnify the effects of changes in EBIT on its EPS.

8. Explain about Operating Leverage.

Operating leverage arises from the existence of fixed operating expenses. So the

degree of operating leverage depends upon the amount of fixed costs. If fixed costs are high even a small decline in sales can lead to a large decline in operating income.

9. What is meant by Optimum Capital Structure?

Optimal capital structure refers to the combination of debt and equity in total capital that maximizes the value of the company. An optimal capital structure is designated as one at which the average cost of capital is the lowest which produces an income that leads to maximization of the market value of the securities.

10. Explain the net income approach of the Capital Structure.

Net income approach was proposed by David Durand. Net Income approach proposes that there is a definite relationship between capital structure and value of the firm. The capital structure of a firm influences its cost of capital (WACC) and thus directly affects the value of the firm. The significance of the NI approach is that a firm can lower its overall cost of capital continuously by increasing the proportion of cheaper debt capital in its capital structure. It leads to an increase in the total value of the firm. If this process continues, the firm will be able to achieve the optimum capital structure.

11. Define the term Working Capital.

Working capital management is the fund available for meeting day-to-day requirements of an enterprise. It is a fact that a part of the fixed or permanent capital is invested in assets, which are kept in the business permanently or for a longer period, for the purpose of earning profit similarly, yet another part of permanent capital available for supporting the day-to-day normal operations, is known as working capital. 12. State the importance of Working Capital.

13. Explain the concept of Gross Working Capital.

Gross (concept) working capital is the amount of funds invested in the various components of current assets. Current assets includes cash in hand, cash at bank, short term investments, debtors, bills receivable, stock of raw materials, work in progress, stock of finished goods, prepaid expenses and advance payment of expenses and other assets which are converted into cash within one year.)

14. Define Operating Cycle Concept.

The term “production cycle” or “manufacturing cycle” refers to the time involvement from cash to purchase of raw materials and completion of finished goods and receipt of cash from sales. If the operating cycle requires a longer time span between cash to cash, the requirement of working capital will be more because of larger tie up of funds in all the processes.

15. Write short note on Dividend.

Dividend may be defined as the return that a shareholder gets from the company, out of its profits, on his shareholdings." In other words, dividend is that part of the net earnings of a corporation that is distributed to its stockholders. It is a payment made to the equity shareholders for their investment in the company.

16. What are the different types of Dividend policy?

- a. Regular dividend policy
- b. Stable dividend policy
- c. Irregular dividend
- d. Zero dividend policy

17. Explain the various forms of Dividend.

- Cash Dividend
- Property Dividend
- Stock Dividend
- Bond Dividend

18. What do you mean by Trading on Equity?

Trading on Equity is a financial process that involves taking more debt to boost the return of the shareholders. Trading on Equity occurs when a company takes new debt, in the form of bonds, preferred stock, or loans etc.

19. What are the sources of External Long Term Finance?

1. Owned capital (Preference and Equity Capital)
2. Debentures
3. Public Deposits
4. Lease Financing
5. Hire Purchase
6. Institutional Assistance
7. Government subsidies
8. Mortgage Bonds
9. Venture Capital

20. What are the sources of Short Term Finance?

1. Trade credit
2. Commercial bank loans
3. Commercial paper, a specific type of promissory note, and
4. Secured loans.