



## **THE NEW COLLEGE (Autonomous)**

**Sponsored by: Muslim Educational Association of Southern India (MEASI)**

**Accredited by NAAC with 'A' Grade (3<sup>rd</sup> cycle)**

**Affiliated to the University of Madras**

**CHENNAI - 600 014.**

## **DEPARTMENT OF BANK MANAGEMENT**

**FINANCIAL MANAGEMENT**

**SUBJECT CODE: 20BBM308**

**PREPARED AND COMPILED**

**BY**

**Dr. V. GUNASEKARAN**

## FINANCIAL MANAGEMENT

### INTRODUCTION:

Finance is the life blood and nerve center of a business, just as circulation of blood is essential in the human body for maintaining life; finance is very essential for smooth running of the business. Finance plays a significant role in all types of businesses whether it is big, medium or small. Without finance one cannot start up business or survive. In order to setup a business enterprise finance is needed which can be obtained from various sources such as bank loan, venture capital, own funds, investors funds, etc.

Once the funds are obtained it used for purchasing assets, further finance is required to meet day to day requirements in terms of managing various costs incurred in routine operations such as payment of rent, salaries, and other obligations such as expansion of business. Therefore, finance is an essential aspect of an enterprise for running and maintaining the business efficiently and effectively.

Financial Management is all about 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:

- “Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations.”- **Massie and Joshep**
- “ FM deals with procurement of funds and their effective utilization in the business”  
- **S C Kuchal**

### SCOPE OF FINANCIAL MANAGEMENT:

- **Investment decisions**- includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.
- **Financial decisions** - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.

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

**Other Scope:**

- FM and Economics: Micro and Macro Environmental Factors.
- FM and Accounting: but interrelated
- FM and Mathematics: Numerical values
- FM and production Management: operating cost
- FM and Marketing: interrelated
- FM and HR Mgt: wages, salaries etc.

**OBJECTIVES OF FINANCIAL MANAGEMENT:**

- I. Wealth Maximization
- II. Profit Maximization

**Wealth Maximization:**

- **It provides efficient allocation of resources**
- To ensure economic interest of the society
- It is superior to the Profit Maximization

**Profit Maximization:**

- Aim is to earn the profits.
- Its the parameter of the business operation
- It reduces the risk of the business concern &
- Main source of finance.

## **OTHER OBJECTIVES OF FINANCIAL MANAGEMENT:**

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

- To ensure **regular and adequate supply** of funds to the concern.
- To ensure **adequate returns** to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders?
- To ensure **optimum funds utilization**. Once the funds are procured, they should be utilized in maximum possible way at least cost.
- To ensure **safety on investment**, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
- 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
  2. Determination of capital composition
  3. Choice of sources of funds
  4. Investment of funds
  5. Disposal of surplus
  6. Management of cash
  7. Financial controls
- 
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-

- Issue of shares and debentures
  - Loans to be taken from banks and financial institutions
  - 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.
  6. **Dividend declaration** - It includes identifying the rate of dividends and other benefits like bonus.
  7. **Retained profits** - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.
  8. **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, maintenance of enough stock, purchase of raw materials, etc.
  9. **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

# FINANCIAL PLANNING

## MEANING / DEFINITION OF FINANCIAL PLANNING:

Financial Planning is the process of estimating the capital required and determining its competition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise.

## OBJECTIVES OF FINANCIAL PLANNING:

- **Determining capital requirements-** This will depend upon factors like cost of current and fixed assets, promotional expenses and long- range planning. Capital requirements have to be looked with both aspects: short- term and long- term requirements.
- **Determining capital structure-** The capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business. This includes decisions of debt- equity ratio- both short-term and long- term.
- **Framing financial policies** with regards to cash control, lending, borrowings, etc.

A finance manager **ensures that the scarce financial resources are maximally utilized in the best possible manner** at least cost in order to get maximum returns on investment.

## IMPORTANCE OF FINANCIAL PLANNING:

- To ensure Adequate funds.
- Financial Planning helps in ensuring a reasonable balance between outflow and inflow of funds so that stability is maintained.
- Financial Planning ensures that the suppliers of funds are invested appropriately and effectively.
- Financial Planning helps in making growth and expansion programmes which helps in long-run survival of the company.
- Financial Planning reduces uncertainties with regards to changing market trends which can be faced easily through enough funds.
- Financial Planning helps in reducing the uncertainties which can be a hindrance to growth of the company. This helps in ensuring stability and profitability in concern.

## FINANCIAL PLANNING PROCESS:



# COST OF CAPITAL

## MEANING OF COST OF CAPITAL

**It is the rate of return** that could have been earned by putting the same money into a different investment with equal risk. Thus, the **cost of capital** is the rate of return required to persuade the investor to make a given investment. It is an integral part of investment decision as it is used to measure the worth of investment proposal provided by the business concern.

## DEFINITION:

- “Cost of capital may be defined as the rate that must be earned on the net processes to provide the cost elements of the burden at the time they are due” -William and Donaldson
- “Cost of Capital is the rate of return the firm required from investment in order to increase the value of the firm in the market place.” - John J Hampton

## CLASSIFICATION OF COST OF CAPITAL

1. **Explicit and Implicit cost**
2. **Average and Marginal Cost**
3. **Historical and Future Cost**
4. **Specific and Combined Cost**

### 1. **Explicit and Implicit cost:**

Explicit Cost is the rate that the firm pays to procure finance. Eg. Rate of debt.

Implicit Cost is the rate of return associated with the best investment opportunity for the firm and its shareholders. Eg. Rate of earnings or profit.

### 2. **Average and Marginal Cost:**

**Average cost** is the rate that a company is expected to pay on an **average** to all its security holders to finance its assets (Capital Employed)



**Marginal cost** is the one; which is **the additional cost** of capital when the company goes for further raising of funds/ finance.

### 3. Historical and Future Cost:

**Historical Cost** which as **already been incurred** for financing a particular project. Eg. Actual Cost incurred in the previous project

**Future Cost** is the expected cost of financing in the proposed project. Eg. **Next project**

### 4. Specific and Combined Cost:

**Specific Cost:** cost of each sources of Capital. Eg: Equity, debt, loan – **specified cost for each.**

**Combined Cost:** also called as **over cost of capital.** It includes total cost associated with the total finance of the firm.

## IMPORTANCE OF COST OF COPITAL:

- To Capital Budgeting Decision
- To Structure Decision
- To evolution of financial performance
- To other financial decision – Managing the finance -eg: earning capacity of securities, market value of shares etc.

## COMPUTATION OF COST OF COPITAL:

- I. Measurement of specific cost
  - Cost of Equity
  - Cost of Debt
  - Cost of Preference Share
  - Cost of Retained earnings
- II. Measurement of overall cost of capital Or Weighted Average Cost of Capital (WACC).

### I. Measurement of specific cost:

- **COST OF EQUITY:** The cost of equity is the return a company requires to decide if an

investment meets capital return requirements. Firms often use it as a capital budgeting threshold for the Required rate of return.

A firm's cost of equity represents the compensation the market demands in exchange for owning the asset and bearing the risk of ownership. The traditional formula for the cost of equity is the dividend capitalization model and the Capital Asset Pricing Model (CAPM).

- **COST OF DEBT: Debt** is money a company has borrowed and must pay back to the lender, often with interest, or money that is owed for goods and services already received by a company. In accounting, debt is classified as either **short-term debt** or **long-term debt**.
- A **short-term debt** is a **debt** that must be paid within one year, while **long-term debt** is not due for a year – more than an year.
- **Short-term** and **long-term debts** are types of business **liabilities** that are reported on a company's balance sheet.
  
- **COST OF PREFERENCE SHARE:** Cost of Preference Share: is that part of **cost of capital** in which we calculate the amount which is payable to **preference shareholders** in the form of dividend with fixed rate.
  
- **COST OF RETAINED EARNINGS :** Cost of Retained earnings: one of the sources of finance for investment proposals. Other than debt, pref. Sh. And equity shares. It is the Cost of equivalent fully subscribed issue of **additional shares**, which is measured by the cost of equity capital.

#### **Assumptions of Cost of Capital:**

- Assumptions are closely associated while calculating and measuring the Cost of Capital.
- There are 3 assumptions:
  1. It is not a cost as such. It is merely a hurdle rate (minimum rate of return).
  2. It is minimum rate of return.
  3. It consists of 3 important risks

- ✓ Zero risk Level
- ✓ Business risk
- ✓ Financial risk

Therefore, there is no single method for calculation of cost of equity.

- If dividend is expected to be constant then **dividend price approach** should be used.
- If earning per share is expected to be constant then **earning price approach** should be used.
- If dividend and earning are expected to grow at a constant rate **then growth approach**, which is also named as Gordon's model should be used.
- If it is difficult to forecast future then **realized yield approach** should be used, which looks into past.
- CAPM

## **METHODS OF CALCULATION OF COST OF EQUITY:**

### **1. DIVIDEND PRICE APPROACH:**

Also known as dividend valuation model. this model makes an assumption that the dividend per share is expected to remain constant forever.

Hence, cost of equity capital is computed by dividing the expected dividend by market price per share as follows:

$$\text{Cost of equity (K}_e\text{)} = D/N_p$$

Where :  $K_e$  = Cost of equity

$D$  = dividend per eq.sh

$N_p$  = Net proceeds of an eq.sh / Market share price

### **2. EARNING/ PRICE APPROACH:**

The advocates of this approach co-relate the earnings of the company with the market price of its share. Accordingly, the cost of equity share capital would be based upon the expected rate of earnings of a company.

$$\text{Cost of Equity (K}_e\text{)} = E/N_p$$

Where,

- $K_e$  = Cost of Equity

- E = Current earnings per share
- $N_p$  = Net proceeds of an eq.sh / Market share price

### 3. GROWTH APPROACH OR GORDON'S MODEL / DIVIDENDPRICE PLUS GROWTH APPROACH:

As per this approach the rate of dividend growth remains constant. Where earnings, dividends and equity share price all grow at the same rate, the cost of equity capital may be computed as follows:

$$\text{Cost of Equity (K}_e\text{)} = D / N_p + g$$

Where,

- D= dividend per eq. sh.
- $N_p$  = Net proceeds of an eq.sh / Market share price
- g = Constant Growth Rate of Dividend.

### 4. REALIZED YIELD APPROACH:

According to this approach, the average rate of return realized in the past few years is historically regarded as '**expected return**' in the future. It computes cost of equity based on the past records of dividends actually realised by the equity shareholders.

$$K_e = P_{vf} * D$$

Where:

- $P_{vf}$  = Present value of discount factor
- D= Dividend per share

### CAPM MODEL: AN OVERVIEW:

1. The capital asset pricing model (CAPM) is a finance theory that establishes a linear relationship **between the required return on an investment and risk**.
2. The model is based on the relationship between an asset's **beta**, the **risk-free rate** (typically the **Treasury bill** rate) and the equity risk premium, or the expected return on

the market minus the risk-free rate.

3. At the heart of the model are - its underlying assumptions, which many have criticize as being unrealistic and which might provide the basis for some of its major drawbacks. No model is perfect, but each should have a few characteristics that make it useful and applicable.

## II. Measurement of overall cost of capital Or Weighted Average Cost of Capital (WACC) Or Dividend Discount Model (DDM):

It is the expected average future cost of funds over the long run.

Calculation:

- Assigning Weights to specific costs
- Multiplying the cost of each of the sources by the appropriate weights.
- Dividing the total weighted cost by the total weights

$$K_o = K_d W_d + K_p W_p + K_e W_e + K_r W_r$$

- K= Cost
- W= Weights

Formula:

$$K_w = \frac{\sum XW}{\sum W}$$

Where:

- $K_w$  -Weighted average cost of capital
- X - Cost of specific sources of finance
- W-Weight, proportion of specific sources of finance

## **FACTORS THAT AFFECT THE WACC:**

1. **Economic conditions:** When banks can easily give loans at low rate of interest to increase their stability, then the company's debt will decrease, and the cost of equity will increase. Well, it is not just limited to bank, it can be said that any economic conditions can be applicable for the same.

2. **Capital structure:** Debt equity ratio will always affect cost of capital because if the debt is greater than share capital, then cost of capital would become more. But if the stock capital exceeds the debt, the pay cost of equity has to be paid.

3. **Dividend policy:** Every company has its dividend policy. The amount of total earning is the company's interest to be paid as dividend.

4. **Receiving new fund:** If any business requires a certain amount immediately for certain purposes, then the company will need paying a real high rate of interest, and with it, the risk of financial institution will also increase. Therefore the company is bound to follow the new rate of cost of capital that might affect business's cost of capital rate.

5. **Financial and investment decisions:** When any business gets a new share capital, they have to mention the causes to fund provider for using their capital. If they find it's too risky, then both of creditors and shareholders will receive high rewards.

6. **Income tax rates:** Any business after earning money, they deduct interest charges, tax charges. Therefore, for higher tax rates it will affect the cost of share capital and vice versa.

7. **Breakpoints of the marginal cost of capital:** Break point is equal to amount of money at which sources of cost of capital changes or proportion of new capital will be raised from this source.

## **SIGNIFICANCE OF COST OF CAPITAL:**

1. **Helps in evaluating financial performance:** if the actual profit of the project is more than the expectation and the actual cost of capital than the performance is said to be satisfactory.

2. **Helps in determining capital mix in capital structure decisions:** it is a rule that there should be a proper debt equity mix and the management has to keep in mind that

the optimum capital structure results in maximum value of the firm and minimize the cost of capital.

**3. Act as acceptance criteria in capital budgeting:** If the present value of expected return from the investment is  $>$  or  $=$  cost of investment the project may be accepted otherwise rejected.

**4. Helps in taking financial decisions:** it helps in taking financial decisions like dividend policy, capitalization of profits, of working capital.

**5. Dividend Decisions:** The concept of capital can be conveniently employed as a tool for making other important financial decisions. On the basis, decisions can be taken regarding dividend policy, capitalization of profits and selections of sources of working capital.

**6.** It helps in **evaluating the investment options**, by converting the future cash flows of the investment avenues into present value by discounting it.

**7.** It is useful in framing optimum credit policy, i.e. at the time of deciding credit period to be allowed to the customers or debtors; it should be compared with the cost of allowing credit period.

### **PROBLEMS:**

#### **Exercise 1**

A company issues 10,000 equity shares of Rs. 100 each at a premium of 10%. The company has been paying 25% dividend to equity shareholders for the past five years and expects to maintain the same in the future also. Compute the cost of equity capital. Will it make any difference if the market price of equity share is Rs. 175?

#### **Solution**

$$\begin{aligned}K_e &= \frac{D}{N_p} \\ &= \frac{25}{100} \times 100 \\ &= 22.72\%\end{aligned}$$

If the market price of a equity share is Rs. 175.

$$\begin{aligned}K_e &= \frac{D}{N_p} \\ &= \frac{25}{175} \times 100 \\ &= 14.28\%\end{aligned}$$

### Exercise 2

- (a) A company plans to issue 10000 new shares of Rs. 100 each at a par. The flotation costs are expected to be 4% of the share price. The company pays a dividend of Rs. 12 per share initially and growth in dividends is expected to be 5%. Compute the cost of new issue of equity shares.

- (b) If the current market price of an equity share is Rs. 120. Calculate the cost of existing equity share capital

#### Solution

(a)

$$K_e = \frac{D}{N_p} + g$$
$$= \frac{12}{100-4} + 5 = 17.5 \%$$

(b)

$$K_e = \frac{D}{N_p} + g$$
$$= \frac{12}{120} + 5\% = 15 \%$$



### Exercise 3

The current market price of the shares of A Ltd. is Rs. 95. The floatation costs are Rs. 5 per share amounts to Rs. 4.50 and is expected to grow at a rate of 7%. You are required to calculate the cost of equity share capital.

#### Solution

Market price Rs. 95

Dividend Rs. 4.50

Growth 7%.

$$\begin{aligned}K_e &= \frac{D}{N_p} + g \\&= \frac{4.50}{95} \times 100 + 7\% \\&= 4.73\% + 7\% = 11.73\%\end{aligned}$$

#### Exercise 4

A firm is considering an expenditure of Rs. 75 lakhs for expanding its operations. The relevant information is as follows :

Number of existing equity shares = 10 lakhs

Market value of existing share = Rs.100

Net earnings = Rs.100 lakhs

Compute the cost of existing equity share capital and of new equity capital assuming that new shares will be issued at a price of Rs. 92 per share and the costs of new issue will be Rs. 2 per share.

#### Solution

Cost of existing equity share capital:

$$K_e = \frac{E}{N_p}$$

$$\text{Earnings Per Share(EPS)} = \frac{100 \text{ lakhs}}{10 \text{ lakhs}} = \text{Rs.}10$$

$$\begin{aligned} K_e &= \frac{10}{100} \times 100 \\ &= 10\% \end{aligned}$$

Cost of Equity Capital

$$\begin{aligned} K_e &= \frac{E}{N_p} \\ &= \frac{10}{92 - 2} \times 100 \\ &= 11.11\% \end{aligned}$$

**Exercise 5**

- (a) A Ltd. issues Rs. 10,00,000, 8% debentures at par. The tax rate applicable to the company is 50%. Compute the cost of debt capital.
- (b) B Ltd. issues Rs. 1,00,000, 8% debentures at a premium of 10%. The tax rate applicable to the company is 60%. Compute the cost of debt capital.
- (c) A Ltd. issues Rs. 1,00,000, 8% debentures at a discount of 5%. The tax rate is 60%, compute the cost of debt capital.
- (d) B Ltd. issues Rs. 10,00,000, 9% debentures at a premium of 10%. The costs of floatation are 2%. The tax rate applicable is 50%. Compute the cost of debt-capital.

In all cases, we have computed the after-tax cost of debt as the firm saves on account of tax by using debt as a source of finance.

**Solution**

$$\begin{aligned}
 \text{(a)} \quad K_{da} &= \frac{I}{N_p} (1-t) \\
 &= \frac{8,000}{1,00,000} \times (1 - 0.5) \\
 &= \frac{8,000}{1,00,000} \times 0.5 \\
 &= 4\%
 \end{aligned}$$

$$\begin{aligned}
 \text{(b)} \quad K_{da} &= \frac{I}{N_p} (1 - t) \\
 N_p &= \text{Face Value} + \text{Premium} = 1,00,000 + 10,000 = 1,10,000 \\
 K_{da} &= \frac{8,000}{1,10,000} \times (1 - 0.6) \\
 &= \frac{8,000}{1,10,000} \times 0.4 \\
 &= 2.91\%
 \end{aligned}$$

$$\begin{aligned}
 \text{(c)} \quad K_{da} &= \frac{I}{N_p} (1 - t) \\
 &= \frac{8,000}{95,000} \times (1 - 0.6) \\
 &= 3.37\%
 \end{aligned}$$

$$\begin{aligned}
 \text{(d)} \quad K_{da} &= \frac{I}{N_p} (1 - t), N_p = \text{Rs. } (10,00,000 + 1,00,000) \times \frac{2}{100} \\
 &= \frac{90,000}{10,78,000} \times (1 - 0.5) \\
 &= 4.17\% = 11,00,000 - 22,000 = \text{Rs. } 10,78,000
 \end{aligned}$$

**Exercise 6**

A company issues Rs. 20,00,000, 10% redeemable debentures at a discount of 5%. The costs of floatation amount to Rs. 50,000. The debentures are redeemable after 8 years. Calculate before tax and after tax. Cost of debt assuring a tax rate of 55%.

**Solution**

$$K_{db} = \frac{I = 1/n (P - N_p)}{1/2(P + N_p)}$$

$$= \frac{20,00,000 + 1/8(20,00,000 + 18,50,000)}{1/2(20,00,000 + 18,50,000)}$$

Note  $N_p = 20,00,000 - 10,00,000 - 50,000$

$$= \frac{2,00,000 + 18750}{19,25,000}$$

$$= 11.36\%$$

After Tax Cost of Debt  $K_{db}$

$$= K_{db} (1 - t)$$

$$= 11.36 (1 - 0.55)$$

$$= 5.11\%$$

**Exercise 7**

XYZ Ltd. issues 20,000, 8% preference shares of Rs. 100 each. Cost of issue is Rs. 2 per share. Calculate cost of preference share capital if these shares are issued (a) at par, (b) at a premium of 10% and (c) of a debentures of 6%.

**Solution**

$$\text{Cost of preference share capital } K_p = \frac{D_p}{N_p}$$

$$(a) \quad K_p = \frac{1,60,000}{20,00,000 - 40,000} \times 100$$

$$= 8.16\%$$

$$(b) \quad K_p = \frac{1,60,000}{20,00,000 + 2,00,000 - 40,000} \times 100$$

$$= 7.40\%$$

$$I K_p = \frac{1,60,000}{20,00,000 - 1,20,000 - 40,000} \times 100$$

$$= \frac{1,60,000}{18,40,000} \times 100$$

$$= 8.69\%$$

### Exercise 8

ABC Ltd. issues 20,000, 8% preference shares of Rs. 100 each. Redeemable after 8 years at a premium of 10%. The cost of issue is Rs. 2 per share. Calculate the cost of preference share capital.

$$K_p = \frac{D_p + (P - N_p)/n}{(P + N_p)/2}$$

$$= \frac{1,60,000 + 1/8 (22,00,000 - 19,60,000)}{1/2(22,00,000 + 19,60,000)}$$

$$= \frac{1,60,000 + 30,000}{20,80,000}$$

$$= 9.13\%$$

where  $D_p = 20,000 \times 100 \times 8\% = 1,60,000$

$$P = 20,00,000 + 2,00,000 = 22,00,00$$

$$N_p = 20,00,000 - 40,000 = 19,60,000$$

$$n = 8 \text{ years}$$

### Exercise 9

ABC Ltd. issues 20,000, 8% preference shares of Rs. 100 each at a premium of 5% redeemable after 8 years at par. The cost of issue is Rs. 2 per share. Calculate the cost of preference share capital.

### Solution

$$K_p = \frac{D_p + (F - N_p)/n}{(P + N_p)/2}$$

$$= \frac{1,60,000 + 1/8 (20,00,000 - 20,60,000)}{1/2 (20,00,000 + 20,60,000)}$$

$$= \frac{1,60,000 - 7,500}{20,30,000}$$

$$= 7.51\%$$

where  $D_p = 20,000 \times 100 \times 8\% = 1,60,000$

$$P = 20,00,000$$

$$n = 8 \text{ years}$$

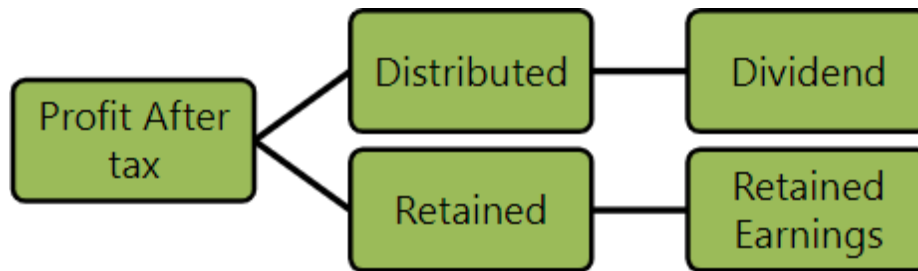
$$N_p = 20,00,000 + 10,00,000 - 40,000 = 20,60,000$$

## DIVIDEND

### MEANING OF DIVIDEND:

Dividend is that part of profit after tax which is distributed to the shareholders of the company. In other words, the profit earned by a company after paying taxes can be used for:

- Distribution of dividend
- Can be retained as surplus for future growth.



### SIGNIFICANCE OF DIVIDEND POLICY

Dividend policy of a firm is governed by:

- Long Term Financing Decision:** As we know that one of the financing options is 'Equity'. Equity can be raised externally through the issue of equity shares or can be generated internally through retained earnings. Retained earnings are preferable because they do not involve flotation costs. Whether to retain or distribute the profits forms the basis of this decision. Since the payment of cash dividends reduces the amount of funds necessary to finance profitable investment opportunities, thereby restricting it to find other avenues of finance. Under this purview, the decision is based on the following:
  - Whether the organization has opportunities in hand to invest the amount of profits, if retained?
  - Whether the return on such investment (ROI) will be higher than the expectations of shareholders.
- Wealth Maximization Decision:** Under this head, we are facing the problem of the amount of dividend to be distributed, i.e., the Dividend Payout ratio (D/P) in relation to the Market Price of the Shares (MPS).  
Because of market imperfections and uncertainty, shareholders give higher value to

near dividends than future dividends and capital gains. Payment of dividends influences the market price of the share. Higher dividends increase value of shares and low dividends decrease it. A proper balance has to be struck between the two approaches.

- iii. When the firm increases retained earnings, shareholders' dividends decrease and consequently market price is affected. Use of retained earnings to finance profitable investments increases future earnings per share. On the other hand, increase in dividends may cause the firm to forego investment opportunities for lack of funds and thereby decrease the future earnings per share. Thus, management should develop a dividend policy which divides net earnings into dividends and retained earnings in an optimum way so as to achieve the objective of wealth maximization for shareholders. Such policy will be influenced by investment opportunities available to the firm and value of dividends as against capital gains to shareholders.

## **DETERMINANTS OF DIVIDEND DECISIONS**

The dividend policy is affected by the following factors:

- 1. Availability of funds:** If the business is in requirement of funds, then retained earnings could be a good source. Since it saves the floatation cost and further the control will not be diluted as in case of further issue of share capital.
- 2. Cost of capital:** If the financing requirements can be financed through debt (relatively cheaper source of finance), then it should be preferred to distribute more dividend but if the financing is to be done through fresh issue of equity shares, it is better to use retained earnings as much as possible.
- 3. Capital structure:** An optimum Debt equity ratio should also be under consideration for the dividend decision.
- 4. Stock price:** Stock price here means market price of the shares. Generally, higher dividends increase value of shares and low dividends decrease it.
- 5. Investment opportunities in hand:** The dividend decision is also affected, if there are investment opportunities in hand, the company may prefer to retain more from the earnings
- 6. Internal rate of return:** If the internal rate of return is more than the cost of



retained earnings, it's better to distribute the earnings as much as possible.

**7. Trend of industry:** Few industries have been seen by investors for regular income, hence in such cases, the firm will have to pay dividend for survival.

**8. Expectation of shareholders:** The shareholders can be categorised in two categories: (i) those who invests for regular income, & (ii) those who invests for growth. Generally, the investor prefers current dividend over the future growth.

**9. Legal constraints:** Section 123 of the Companies Act, 2013 came into force from 1st April, 2014 which provides for declaration of dividend.

**10. Taxation:** As per Section 115-O of Income Tax Act, 1961, dividend is subject to dividend distribution tax (DDT) in the hands of the company. Under the existing provisions of Section 10(34) of the Act dividend which suffer DDT under section 115-O is exempt in the hands of the shareholder.

## **DIVIDEND POLICY**

It means when company earns profit , then company need to decide what to do , whether distribute all PAT to shareholders or retained for future growth of the company.

### **Types of Dividend Policy**

- Regular dividend Policy
- Stable dividend Policy
- Irregular dividend Policy
- No dividend Policy

#### **1. Regular dividend Policy**

The company follow the procedure to pay out the dividend to it's shareholders every year. If company earns **ABNORMAL PROFIT** (AP= Actual Profit – Expected Profit) then it retains the extra profit on the other side if it remains in loss any year then also it pays the dividend .This kind of policy adopted by those companies who are having stable earnings and steady cashflow. The class of investors putting their money into these companies is generally risk averse who mainly belongs to the retire and weaker section of the society's and aims at regular income .The main demerit of this policy is investors cannot expect an increase in dividend even in if the

market is relatively booming high.

## **2. Stable dividend Policy**

Under this type of dividend policy, the company follows the procedure to pay out a defined fixed percentage of profits as dividends every year. For example, suppose a company sets the payout rate at 10% then this percentage of profit will be paid out as dividends every year regardless of the quantum of profit.

For example Whether a company makes a profit of \$1 million or \$200000, a fixed rate of dividend will be paid out to the shareholders. In the eyes of investors, the company adopting this policy is considered as risky because amount of dividend fluctuates with the level of profit.

## **3. Irregular dividend Policy**

Under this type of dividend policy company states that it has no obligation in respect of paying dividend. The quantum and rate of dividend will be decided by the board of directors who will take the decision in respect of action to be taken with earned profit. The board might take the decision to distribute dividend for gaining confidence among the investors so that they will invest more into the company and companies' liquidity will increase.

On the other hand, board take the decision distribute no or less amount of dividend with the aim of increasing the growth of the companies by using retained earnings.

Moreover, this type of dividend policy adopted by companies having irregular cash flow.

## **4. No dividend Policy**

Under this policy, the company follow the procedure of paying no dividend to the shareholders and dividend payout ratio is zero percent. The total earnings will be retained by the company with the objective of re investing into company model of business to expand it further with an increased rate and without hurdling to the issues like liquidity .

## **WORKING CAPITAL MANAGEMENT**

### **MEANING AND CONCEPT OF WORKING CAPITAL**

In accounting term working capital is the difference between current assets and current liabilities.

If we break down the components of working capital we will found working capital as follows:

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

**Current Assets:** An asset is classified as current when:

- I. It is expected to be realised or intends to be sold or consumed in normal operating cycle of the entity;
- II. The asset is held primarily for the purpose of trading;
- III. It is expected to be realised within twelve months after the reporting period;

It is non- restricted cash or cash equivalent. Generally current assets of an entity, for the purpose of working capital management can be grouped into the following main heads:

- i. Receivables (trade receivables and bills receivables).
- ii. Inventory (raw material, work in process and finished goods)
- iii. Cash or cash equivalents (short-term marketable securities)
- iv. Prepaid expenses
- v. Receivables (trade receivables and bills receivables)

**Current Liabilities:** A liability is classified as current when:

- (i) It is expected to be settled in normal operating cycle of the entity.
- (ii) The liability is held primarily for the purpose of trading
- (iii) It is expected to be settled within twelve months after the reporting period Generally current liabilities of an entity, for the purpose of working capital management can be grouped into the following main heads:

- (a) Payable (trade payables and bills receivables)
- (b) Outstanding payments (wages & salary etc.)

In general Working capital management is essentially managing Current Assets. Management of working capital arises as a part of the process of such management.

## **NEEDS OF WORKING CAPITAL**

Working Capital is an essential part of the business concern. Every business concern must maintain certain amount of Working Capital for their day-to-day requirements and meet the short-term obligations. Working Capital is needed for the following purposes.

- 1. Purchase of raw materials and spares:** The basic part of manufacturing process is, raw materials. It should purchase frequently according to the needs of the business concern. Hence, every business concern maintains certain amount as Working Capital to purchase raw materials, components, spares, etc.
- 2. Payment of wages and salary:** The next part of Working Capital is payment of wages and salaries to labour and employees. Periodical payment facilities make employees perfect in their work. So a business concern maintains adequate the amount of working capital to make the payment of wages and salaries.
- 3. Day-to-day expenses:** A business concern has to meet various expenditures regarding the operations at daily basis like fuel, power, office expenses, etc.
- 4. Provide credit obligations:** A business concern responsible to provide credit facilities to the customer and meet the short-term obligation. So, the concern must provide adequate Working Capital.

## **FACTORS DETERMINING WORKING CAPITAL REQUIREMENTS**

Working Capital requirements depends upon various factors. There are no set of rules or formula to determine the Working Capital needs of the business concern. The following are the major factors which are determining the Working Capital requirements.

- 1. Nature of business:** Working Capital of the business concerns largely depend upon the nature of the business. If the business concerns follow rigid credit policy and sell goods only for cash, they can maintain lesser amount of Working Capital. A transport company maintains lesser amount of Working Capital while a construction company maintains larger

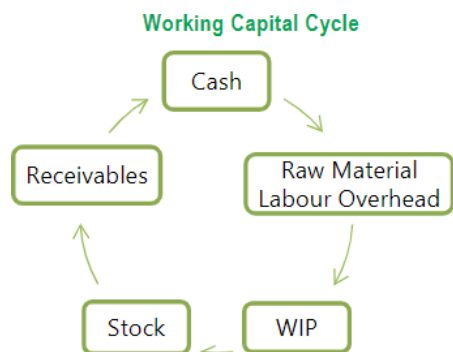
amount of Working Capital.

2. **Production cycle:** Amount of Working Capital depends upon the length of the production cycle. If the production cycle length is small, they need to maintain lesser amount of Working Capital. If it is not, they have to maintain large amount of Working Capital.
3. **Business cycle:** Business fluctuations lead to cyclical and seasonal changes in the business condition and it will affect the requirements of the Working Capital. In the booming conditions, the Working Capital requirement is larger and in the depression condition, requirement of Working Capital will reduce. Better business results lead to increase the Working Capital requirements.
4. **Production policy:** It is also one of the factors which affects the Working Capital requirement of the business concern. If the company maintains the continues production policy, there is a need of regular Working Capital. If the production policy of the company depends upon the situation or conditions, Working Capital requirement will depend upon the conditions laid down by the company.
5. **Credit policy:** Credit policy of sales and purchase also affect the Working Capital requirements of the business concern. If the company maintains liberal credit policy to collect the payments from its customers, they have to maintain more Working Capital. If the company pays the dues on the last date it will create the cash maintenance in hand and bank.
6. **Growth and expansion:** During the growth and expansion of the business concern, Working Capital requirements are higher, because it needs some additional Working Capital and incurs some extra expenses at the initial stages.
7. **Availability of raw materials:** Major part of the Working Capital requirements are largely depend on the availability of raw materials. Raw materials are the basic components of the production process. If the raw material is not readily available, it leads to production stoppage. So, the concern must maintain adequate raw material; for that purpose, they have to spend some amount of Working Capital.
8. **Earning capacity:** If the business concern consists of high level of earning capacity, they can generate more Working Capital, with the help of cash from operation. Earning capacity is also one of the factors which determine the Working Capital requirements of the business concern.

## OPERATING/WORKING CAPITAL CYCLE

Definition of Working Capital cycle indicates the length of time between a company's paying for materials, entering into stock and receiving the cash from sales of finished goods. It can be determined by adding the number of days required for each stage in the cycle. For example, a company holds raw materials on an average for 60 days, it gets credit from the supplier for 15 days, production process needs 15 days, finished goods are held for 30 days and 30 days credit is extended to debtors. The total of all these, 120 days, i.e.,  $60 - 15 + 15 + 30 + 30$  days is the total working capital cycle.

The faster a business expands the more cash it will need for working capital and investment. The cheapest and best sources of cash exist as working capital right within business. Good management of working capital will generate cash which will help improve profits and reduce



risks. Bear in mind that the cost of providing credit to customers and holding stocks can represent a substantial proportion of a firm's total profits. Each component of working capital (namely inventory, receivables and payables) has two dimensions Time and Money, when it comes to managing working capital then time is money. If you can get money to move faster around the cycle (e.g. collect monies due from debtors more quickly) or reduce the amount of money tied up (e.g. reduce inventory levels relative to sales), the business will generate more cash or it will need to borrow less money to fund working capital. Similarly, if you can negotiate improved terms with suppliers e.g. get longer credit or an increased credit limit; you are effectively creating free finance to help fund future sales.

The length of operating cycle is the indicator of performance of management. The net operating cycle represents the time interval for which the firm has to negotiate for Working Capital from its bankers. It enables to determine accurately the amount of working capital

needed for the continuous operation of business activities.

In the form of an equation, the operating cycle process can be expressed as follows:

$$\text{Operating Cycle} = R + W + F + D - C$$

Where,

R = Raw material storage period

W = Work-in-progress holding period

F = Finished goods storage period

D = Receivables (Debtors) collection period

C = Credit period allowed by suppliers (Creditors)

### **TYPES OF WORKING CAPITAL:**

The working capital need can be bifurcated into permanent working capital and temporary working capital.

**1. Permanent working capital-** There is always a minimum level of working capital which is continuously required by a firm in order to maintain its activities like cash, stock and other current assets in order to meet its business requirements irrespective of the level of operations.

**2. Temporary working capital:**

Over and above the permanent working capital, the firm may also require additional working capital in order to meet the requirements arising out of fluctuations in sales volume. This extra working capital needed to support the increased volume of sales is known as temporary or fluctuating working capital

## CAPITAL BUDGETING

It is the planning process used to determine whether an organization's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects are worth the funding of cash through the firm's capitalization structure.

It is the process of allocating resources for major capital, or investment, expenditures.

### DEFINITION: CAPITAL

Capital refers to the financial resources that businesses can use to fund their operations like cash, machinery, equipment and other resources. These are the assets that allow the business to produce a product or service to sell to customers.

### DEFINITION OF BUDGET

- **Budgeting** is a management tool for planning and controlling future activity.
- **Budget** is a financial plan and a list of all planned expenses and revenues.

### DEFINITION CAPITAL BUDGETING

“Capital Budgeting is acquiring inputs with long – terms returns” – Richard and Green  
Law

“CB is a long-term planning for making and financing proposed capital out lays”. –Charles T  
Hron green

### NEED AND IMPORTANCE OF CAPITAL BUDGETING

1. **Huge investments:** Capital budgeting requires huge investments of funds, but the available funds are limited, therefore the firm before investing projects, plan are control its capital expenditure.
2. **Long-term:** Capital expenditure is long-term in nature or permanent in nature. Therefore financial risks involved in the investment decision are more. If higher risks are involved, it needs careful planning of capital budgeting.
3. **Irreversible:** The capital investment decisions are irreversible, are not changed back. Once the decision is taken for purchasing a permanent asset, it is very difficult to dispose off those assets without involving huge losses.



4. **Long-term effect:** Capital budgeting not only reduces the cost but also increases the revenue in long-term and will bring significant changes in the profit of the company by avoiding over or more investment or under investment. Over investments leads to be unable to utilize assets or over utilization of fixed assets. Therefore before making the investment, it is required carefully planning and analysis of the project thoroughly.

## **CAPITAL BUDGETING PROCESS**

Capital budgeting is a difficult process to the investment of available funds. The benefit will attained only in the near future but, the future is uncertain. However, the following steps followed for capital budgeting, then the process may be easier are.

1. **Identification of various investments proposals:** The capital budgeting may have various investment proposals. The proposal for the investment opportunities may be defined from the top management or may be even from the lower rank. The heads of various department analyse the various investment decisions, and will select proposals submitted to the planning committee of competent authority.
2. **Screening or matching the proposals:** The planning committee will analyse the various proposals and screenings. The selected proposals are considered with the available resources of the concern. Here resources referred as the financial part of the proposal. This reduces the gap between the resources and the investment cost.
3. **Evaluation:** After screening, the proposals are evaluated with the help of various methods, such as pay back period proposal, net discovered present value method, accounting rate of return and risk analysis.
4. **Fixing property:** After the evolution, the planning committee will predict which proposals will give more profit or economic consideration. If the projects or proposals are not suitable for the concern's financial condition, the projects are rejected without considering other nature of the proposals.
5. **Final approval:** The planning committee approves the final proposals, with the help of the following:
  - (a) Profitability
  - (b) Economic constituents

(c) Financial viability

(d) Market conditions.

The planning committee prepares the cost estimation and submits to the management.

6. **Implementing:** The competent authority spends the money and implements the proposals. While implementing the proposals, assign responsibilities to the proposals, assign responsibilities for completing it, within the time allotted and reduce the cost for this purpose. The network techniques used such as PERT and CPM. It helps the management for monitoring and containing the implementation of the proposals.
7. **Performance review of feedback:** The final stage of capital budgeting is actual results compared with the standard results. The adverse or unfavorable results identified and removing the various difficulties of the project. This is helpful for the future of the proposals.