

FAA- 5th sem

Subject- 5.2 Financial management

Introduction and Meaning

Finance is the life blood of business. Finance may be defined as the art and science of managing money. Finance also is referred as the provision of money at the time when it is needed. Finance function is the procurement of funds and their effective utilization in business concerns. Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations. Financial management is that activity of management that is concerned with the planning, procuring and controlling of the firm's financial resources. Thus, financial management includes –

- (i) Determining the capital requirements of the firm
- (ii) Raising of sufficient funds to make an ideal or optimum capital structure
- (iii) Allocating the funds among various types of assets
- (iv) Financial control so as to ensure efficient use of funds.

DEFINITION OF FINANCIAL MANAGEMENT

“Financial management is the activity concerned with planning, raising, controlling and administering of funds used in the business.” – Guthman and Dougal

“Financial management is that area of business management devoted to a judicious use of capital and a careful selection of the source of capital in order to enable a spending unit to move in the direction of reaching the goals.” – J.F. Brandley

NATURE OF FINANCIAL MANAGEMENT

Nature of Financial Management:

- a) **Continuous Process:** Financial Management is a continuous process. There is a requirement of finance in all the activities of an organization. Hence, financial management is a continuous process.
- b) **Goal-oriented Process:** It is goal-oriented process. The objective of financial management is to maximize the wealth of shareholders.
- c) **Inter-disciplinary Activity:** It is an inter-disciplinary activity. All the activities of business (like marketing, production, research etc.) require finance in some way or the other. Hence, Financial Management is to be done keeping in mind all the activities.
- d) **Influenced by External factors:** Financial Management is also influenced by external

factors which are beyond the control of firm, e.g. economic conditions, inflation, position of stock market etc.

- e) It's all pervasive: Financial Management is needed in every business organization, be it any business company, NGO or any educational institution. Finance is needed in every entity and so does Financial Management.

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.

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 encourages corrupt practices
- It does not consider the element of risk
- Time value of money is not reflected
- Attracts cut-throat competition
- Huge profits attract government intervention

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 prices 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 considers the time value for money
- 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.

Basis	Wealth Maximization	Profit Maximization
Meaning	It is defined as the management of financial resources aimed at increasing the value of the stakeholders of the company	It is defined as the management of financial resources aimed at increasing the profit of the company.
Focus	Focuses on increasing the value of the stakeholders of the company in the long term	Focuses on increasing the profit of the company in the short term
Risk	It considers the risks and uncertainty inherent in the business model of the company.	It does not consider the risks and uncertainty inherent in the business model of the company
Usage	It helps in achieving a larger value of a company's worth which may reflect in the increased market share of the company	It helps in achieving efficiency in the company's day-to-day operations to make the business profitable.

SCOPE OF FINANCIAL MANAGEMENT

The Traditional Approach:

The traditional approach to the finance function relates to the initial stages of its evolution during 1920s and 1930s. According to this approach, the scope, of finance function was confined to only procurement of funds needed by a business on most suitable terms. The utilisation of funds was

considered beyond the purview of finance function. It was felt that decisions regarding the application of funds are taken somewhere else in the organisation. However, institutions and instruments for raising funds were considered to be a part of finance function. The traditional approach suffers from many serious limitations:

1. It is outsider-looking in approach that completely ignores internal decision making as to the proper utilisation of funds.
2. The focus of traditional approach was on procurement of long-term funds. Thus, it ignored the important issue of working capital finance and management.
3. The issue of allocation of funds, which is so important today, is completely ignored.

The Modern Approach:

The modern approach views finance function in broader sense. It includes both raising of funds as well as their effective utilisation under the purview of finance. The finance function does not stop only by finding out sources of raising enough funds; their proper utilisation is also to be considered. The cost of raising funds and the returns from their use should be compared. The funds raised should be able to give more returns than the costs involved in procuring them. The utilisation of funds requires decision making. Finance has to be considered as an integral part of overall management. So finance functions, according to this approach, covers financial planning, raising of funds, allocation of funds, financial control etc. The modern approach considers the three basic management decisions within the scope of finance function., i.e.,

- Investment decisions,
- Financing decisions and
- Dividend decisions
- Dividend decisions

All the decisions taken by a finance manager are known as “Financial Decision”. The detailed explanation of these decisions is provided below.

- Investment Decision: This means deciding how much amount will be invested and in which assets. There are two types of assets in an organization: Fixed Assets and Current Assets. Fixed Assets are those assets which are purchased for long-term use in business and are not meant for resale. Examples of fixed assets are: Furniture, Land and Building, Plant and machinery etc. Current assets are those assets which will get converted into cash within a short span of time, usually taken as one year. Examples of Current Assets are: Cash, Cash at Bank, Stock, Debtors, Bills Receivable, Prepaid expenses etc. Thus in

investment decision, a finance manager has to decide in which assets amount should be invested and how much. Investment decision is of two types: Capital Budgeting and Working Capital Management. Decision regarding investment in fixed assets is known as capital budgeting, while the decision related to investment in current assets is known as working capital management.

- **Financing Decision:** In Financing decision, a manager decides from where she should raise money. There are various sources of finance. These sources may be categorized into two parts: Short-term sources and Long-term sources. Short-term sources are the sources which help raise funds for a short span of time, like up to one year. Examples of short-term sources of finance: Bank overdraft, cash credit, call money, commercial papers etc. Long-term sources are the sources which help raise funds for a long span of time, usually for many years. Examples of long-term sources of finance: Equity shares, Preference shares, Debentures, Long-term loans etc. Decision regarding how much money should be raised from each source is called Financing Decision.
- **Dividend Decision:** In dividend decision, it is decided how much profits of the company would be distributed among shareholders and how much would be retained. It is not necessary for the company to distribute all the profits to the equity shareholders. A company can retain its profits for further investment. The part of profits retained in business is called retained earnings. Thus, in dividend decision, dividend payout ratio (percentage of profits that is to be paid to shareholders) is decided.

DUTIES AND RESPONSIBILITIES OF FINANCIAL MANAGER (OR) FUNCTIONS OF FINANCIAL MANAGER OR ROLE OF FINANCIAL MANAGER

Finance manager is an integral part of corporate management of an organization. With his profession experience, expertise knowledge and competence, he has to play a key role in optimal utilization of financial resources of the organization. With the growth in the size of the organization, degree of specialization of finance function increases. In large undertakings, the finance manager is a top management executive who participates in various decision making functions.

A) **Determining financial needs:-** One of the most important functions of the financial manager is to ensure the availability of adequate financing, financial needs have to be assessed for different purposes. Money may be required for initial promotional expenses, fixed capital

and working capital needs. Promotional expenditure includes expenditure incurred in the process of company formation.

B) Determining sources of funds:- The financial manager has to choose source of funds. He may issue different types of securities and debenture, may borrow from a number of finance institutional and the public. The financial manager must definitely know what he is doing, workout strategies to ensure good financial health of the firm.

C) Financial analysis:- It is the evaluation & interpretation of a firm's financial position and operation and involves a comparison and interpretation of accounting data. The financial manager has to interpret different statements.

D) Optimal capital structure:- The financial manager has to establish an optimum capital structure and ensure the maximum rate of return on investment and the liabilities carrying – fixed charges has to be defined.

E) Cost –volume profit analysis;- This is popularly known as the CVP relationship for this purpose are fixed cost, variable cost and semi-variable cost have to be analyzed.

F) Profit planning and control:- Profit planning and control have assumed great importance in the financial activities of modern business. Profit planning ensures the attainment of stability and growth. The break even analysis and cost volume profit analysis are important tools in profit planning and control of the firms.

G) Fixed assets management:- A firm's fixed assets are land, building, machinery and equipment, furniture and such intangibles as patents, copy rights and goodwill. These fixed assets are justified to the extent of the utility or their production capacity.

H) Capital budgeting:- It refers to the long-term planning for

(1) investment in projects and fixed assets and

(2) methods of financing the approved projects. It includes the methods of mobilization of long-term funds and their deployments in profitable projects. Capital budgeting is considered as the process of making investment decisions on capital expenditure.

I) Dividend policies:- The dividend policy of a firm determines the magnitude of the earnings distributed to share holders. The net operating profit or profit after tax (PAT) has to be intelligently apportioned between dividend payments, and investments. The dividend policy determines the amount of dividend payment to be made to the shareholders, the date of payments of dividends and the effect of the dividend policy on the value of the firm.

J) Acquisition and mergers:- A merger is a transaction where two firms agree to integrate their operations on a relatively equal basis because they have resources and capabilities that together may create a stronger competitive advantage. Two or more companies combine to form either a new company or one of the combining companies survives, which is generally the acquirer

UNIT- II. TIME VALUE OF MONEY

Topics covered-

- a. Meaning
- b. Importance and Objectives
- c. Methods: Compound Value, Present Value, Net Present Value (Theoretical Concepts)

Meaning and Concept of Time Value of Money

Time value of money is a concept in Financial Management that states that the value of one rupee is not same every time. It means that value of one rupee today is more than the value of same rupee received one year later. It happens because you may invest one rupee received today and earn interest on that and after one year it will convert into Rs. 1.10, assuming the rate to be 10% per annum. It means that Time Value of Money tells us that value of money decreases with the passage of time.

Let's take an example, if you have Rs. 100 today. If rate of interest is 10% per annum and if you invest it for one year, it will get converted into Rs. 110 at the end of one year. So, we can say that in this situation, Rs. 100 of today is equal to Rs. 110 at the end of first year. Thus, value of a rupee changes with the change in time.

Importance and Objectives

Time value of money is an important concept which helps in taking financial decisions wisely. It is helpful in evaluating worth of a decision in a situation where cash-inflows and cash-outflows happen at different time. Following are the examples:

- a. When we take a loan, cash-inflows happen at present and cash-outflows will take place

in future. To compare cash-inflows and cash-outflows, we use the concept of time value of money.

- b. When we purchase a fixed asset, the cash outflows happen at present, but benefits of the project (cash-inflows) would happen in future time. To compare these cash-flows, we use the concept of time value of money.
- c. Time value of money gives us true assessment of risk. It is only because of time value of money, we can get true picture of financial position of an individual or a business.
- d. Time value of money is helpful in comparing and choosing investment plan.

Thus, Time Value of Money is an important concept that helps in financial decision-making, where there is a time gap between cash inflows and cash outflows. With the help of this concept, both cashflows are brought to one common point (by calculating Present Value of future Cashflows or by computing Compound Value of present cashflows). Then we compare both the cashflows and take decisions accordingly. If Present Value of Cash inflow is greater than Present Value of Cash outflow, we accept that decision and vice-versa.

Concepts: Compound Value, Present Value, Net Present Value

Net Present Value: Concept of Net Present Value is helpful in decision making when cash inflows and cash outflows take place in different time periods. Net Present Value is the excess of Present Value of Cash-inflows over Present Value of Cash-outflows. It is computed with the help of following formula:

$$NPV = PV \text{ of Cash-inflows} - PV \text{ of Cash-outflows}$$

If Net Present Value of a project is positive, business should invest money in it. If Net Present Value is negative, then that project should not be undertaken

Compound Value: Compound Value of an amount is the total sum that a person receives after a specific period, when she invests her money. For example, if Preeti invests Rs. 1000 at 10% rate of interest for 1 year, she will receive Rs. 1100 at the end of first year. Rs. 1,100 is called the future value or the compound value.

Computation of Compound Value: There may be two cases:-

- a. *When it is a case of Simple interest*
- b. *When it is a case of Compound interest*

a. When it is a case of simple interest: In such a case, following formula is used to compute

compound value:

Compound Value or Future Value = Principal or Present Value + Simple Interest for n number of years

$$CV = P + SI$$

Simple Interest = Principal X Rate of interest X No of years
 $SI = P * r * n$

Where,

P = Principal

r = Rate of interest

n = No of years

- b. When it is a case of Compound Interest: In case of Compound interest, every year amount of interest would increase as interest would be calculated on accumulated amount.

For example, if RoshanTara invests Rs. 1000 at 10% rate of interest compounded annually for 2 years, then the accumulated amount she will receive after 2 years would be calculated as under:

Year	Principa l	Interest	Amoun t
1	1,000	100	1,100
2	1,100	110	1,210

This can also be solved with the help of following formula

Compound Value/Future Value = Principal $(1 + \text{rate})^{\text{no of years}}$

$$CV = P (1+r)^n$$

Where, P = Principal (Amount invested in the beginning) r = Rate of interest

n = Number of

years In the above example, $CV = 1,000 (1+0.1)^2$

$$CV = 1,000 (1.1)^2 = 1,210 = \text{Rs. 1210}$$

Present Value: Present Value is the amount that you need to invest today to get a specific amount in future after a specified period. For example, if Monali invests Rs. 1,000 today at 10% rate of interest, she will get Rs. 1,100 at the end of first year. Thus, Rs. 1,000 is the present value of Rs. 1,100 of one year later.

To compute Present Value, following formula is used:

$$PV = \frac{CV}{(1 + r)^n}$$

Where, PV= present value

CV = Compound Value or Future

Value R= Rate of interest

N = Number of

years

UNIT III: SOURCES OF FINANCE AND CAPITAL STRUCTURE

Topics covered-

- a. Short-term sources of Finance
- b. Long-term sources of finance
- c. Meaning and importance of capital structure
- d. Factors influencing capital structure

Financing decision means deciding the sources of finance. There are two types of sources of finance: Short-term sources of finance and Long-term sources of finance. Short-term sources of finance are those sources which provide funds to business for a short time-period, usually less than one year. Examples of short-term sources of finance are: Creditors, Short-term loans, Bank overdraft etc. Long- term sources are those sources which provide funds for long time period, that is more than one year. Examples of long-term sources of finance are: Equity shares, Preference Shares, Debentures, Long- term loans, Retained earnings etc.

Short-term Sources of Finance

The sources of short-term funds used for financing variable part of working capital mainly include the following:

1. Loans from Commercial Banks: Small-scale enterprises can raise loans from the commercial banks with or without security. This method of financing does not require any legal formality except that of creating a mortgage on the assets. Loan can be paid in lump sum or in parts
2. Public Deposits: Often companies find it easy and convenient to raise short- term funds by inviting shareholders, employees and the general public to deposit their savings with the company. It is a simple method of raising funds from public for which the company has only to advertise and inform the public that it is authorised by the Companies Act 1956, to accept public deposits.
3. Trade Credit: Just as the companies sell goods on credit, they also buy raw materials, components and other goods on credit from their suppliers. Thus, outstanding amounts payable to the suppliers i.e., trade creditors for credit purchases are regarded as sources of finance. Generally, suppliers grant credit to their clients for a period of 3 to 6 months. Thus, they provide, in a way, shortterm finance to the purchasing company.

4. Discounting Bills of Exchange: When goods are sold on credit, bills of exchange are generally drawn for acceptance by the buyers of goods. The bills are generally drawn for a period of 3 to 6 months. In practice, the writer of the bill, instead of holding the bill till the date of maturity, prefers to discount them with commercial banks on payment of a charge known as discount.

5. Factoring: Factoring is a financial service designed to help firms in managing their book debts and receivables in a better manner. The book debts and receivables are assigned to a bank called the factor and cash is realised in advance from the bank. For rendering these services, the fee or commission charged is usually a percentage of the value of the book debts/receivables factored. This is a method of raising short-term capital and known as factoring.

6. Bank Overdraft: Overdraft is a facility extended by the banks to their current account holders for a short period generally a week. A current account holder is allowed to withdraw from its current deposit account up to a certain limit over the balance with the bank. The interest is charged only on the amount actually overdrawn. The overdraft facility is also granted against securities.

7. Cash Credit: Cash credit is an arrangement whereby the commercial banks allow borrowing money up to a specified limit known as „cash credit limit.“ The cash credit facility is allowed against the security. The cash credit limit can be revised from time to time according to the value of securities. The money so drawn can be repaid as and when possible. The interest is charged on the actual amount drawn during the period rather on limit sanctioned. Arranging overdraft and cash credit with the commercial banks has become a common method adopted by companies for meeting their short-term financial, or say, working capital requirements.

8. Advances from Customers: One way of raising funds for short-term requirement is to demand for advance from one's own customers. Examples of advances from the customers are advance paid at the time of booking a car, a telephone connection, a flat, etc. This has become an increasingly popular source of short-term finance among the small business enterprises mainly due to two reasons. The enterprises do not pay any interest on advances from their customers. Thus, advances from customers become one of the cheapest sources of raising funds for meeting working capital requirements of companies.

9. Accrual Accounts: Generally, there is a certain amount of time gap between incomes earned and is actually received or expenditure becomes due and is actually paid. Salaries, wages and taxes, for example, become due at the end of the month but are usually paid in the first week of the next month. Thus, the outstanding salaries and wages as expenses for a week helps the

enterprise in meeting their working capital requirements. This source of raising funds does not involve any cost.

Long-term Sources of Finance

EQUITY SHARES

Equity Shares: Authorised capital of a company is divided into many small parts. Each such part is known as a “share.” The company issues shares, public purchases it and company gets money this way. Following are the main features of Equity shares:

- a. Equity shareholders are the *real owners* of the company.
- b. Equity shareholders have *voting rights*. They choose the Board of Directors, who manages the company.
- c. The equity shareholders get dividend in return. However, the *rate of dividend is not fixed* on these shares. Even if the company has sufficient profits, company may decide not to distribute any dividend to equity shareholders.
- d. When a company is wound up/ closed, they are *the last to receive* their payment.
- e. There is *no deduction of tax* on equity dividend because equity dividend is paid after paying taxes.
- f. There is *no maturity period* of equity shares. So a company need not return their principal amount back to the shareholders ever.
- g. Equity shares are the *least risky source from the viewpoint of company*, as there is no necessity of paying regular dividend.
- h. *From investor's viewpoint*, equity shares are *most risky* investment, as there is no guarantee of dividend even if the company earns adequate profits.
- i. Equity shareholders have *limited liability*. In case a company faces loss, equity shareholders are liable to pay the amount of their shares only. If they have paid full amount of their shares, then nothing more can be claimed from them.
- j. Equity shares are *liquid investments*. It means that these shares can be sold to other persons very easily through stock market.

PREFERENCE SHARES

Preference Shares: Preference shares are those shares which get preference over equity shares, both at time of receiving regular dividend and the principal amount (at the time of closing down of a company). Following are the main features of Preference shares:

- a. Preference shareholders are not the real owners of the company.

- b. Preference shareholders *don't have voting rights*.
- c. The preference shareholders get dividend in return and *the rate of dividend is fixed* on these shares. However, the dividend is paid only if the company earns a profit.
- d. When a company is wound up/ closed, they get *preference over equity shareholders* to receive their payment.
- e. There is *no deduction of tax* on preference dividend because preference dividend is paid after paying taxes.
- f. Preference shares may be *redeemable or irredeemable*. There is no maturity period of irredeemable preference shares. So a company need not return their principal amount back to the shareholders ever. In case of redeemable preference shares, company needs to repay the amount after the fixed maturity period.
- g. Preference shares are *riskier than equity shares from the viewpoint of company*, as there is a necessity of paying fixed dividend.
- h. *From investor's viewpoint, preference shares are less risky than equity shares* as a form of investment, as there is no guarantee of dividend even if the company earns adequate profits.
- i. Preference shareholders have *limited liability*. In case a company faces loss, preference shareholders are liable to pay the amount of their shares only. If they have paid full amount of their shares, then nothing more can be claimed from them.
- j. Preference shares may be *convertible or non-convertible*. Convertible preference shares are those shares where shareholders get a chance to convert their shares into equity shares after a fixed time. Non-convertible preference shares cannot be converted into equity shares.

DEBENTURES

Debentures: Debenture is like a certificate that is an acknowledgement of debt. This certificate is negotiable/transferable. It means that a debenture can be transferred (sold and purchased) from one holder to the other. Following are the *main features* of debentures:

- a. There is a *fixed rate of interest* on debentures.
- b. Interest on debentures is to be paid, even if company doesn't earn a profit. Thus interest on debentures is a *charge against profits*.
- c. The debenture-holders are *not the owners* of the company and hence, they don't have any voting rights.

- d. The debentures are a *cheap source of finance*. It is because company gets a *tax deduction* because of interest paid on debentures. Tax is paid after the interest is paid on debentures.
- e. Debenture is a *risky source of finance from company's point of view*. It is so because interest needs to be paid, even if the company is running into losses.
- f. Debentures are *least risky from the viewpoint of investors*. It is so because investor will get their money back even if company is not earning profits.
- g. Debentures may be *redeemable or irredeemable*. Redeemable debentures have fixed maturity period, after which company needs to repay the principal amount. In case of irredeemable debentures, principal amount is not repaid, only interest is paid regularly forever.
- h. Debentures may be *convertible or non-convertible*. Convertible debentures are those which can be converted into equity shares or preference shares after a fixed period. Non-convertible debentures are those which cannot be converted.
- i. Debenture-holders *get the interest before any payment is made to preference and equity shares*. Similarly, when a company is wound up, they get their money back before anything is paid to shareholders.

Thus, Debentures are a cheap source of finance for the company because of tax deduction. But it is riskier to use more debentures, because company needs to pay interest even if there is a loss.

Apart from this classification, sources of finance can also be classified as internal as well as external sources of finance.

EXTERNAL SOURCES:

1. Preference Shares: Preference shares have two preferential rights, one at the time of payment of dividend and second repayment of capital at the time of liquidation of the company. Preference shares have no voting rights and normally have no control over the policies. Finance through preference shares is less costly as compared to the equity shares. However, compared to equity capital it is a very expensive source of financing. Though there is no legal obligation to pay preference dividends, skipping them can adversely affect the image of the firm in the capital market.

2. **Equity Shares:** The equity shares are the main sources of finance and the owners of the company contribute it. It is the source of permanent capital since it does not have a maturity date. The holders of equity shares have a control over the working of the company. These shares are issued without creating any charge over the assets of the company. The major advantage to raise funds through equity shares is that it does not involve any fixed obligation for payment of dividends. The disadvantage of raising funds by way of equity capital is high cost of capital. The rate of return required by equity shareholders is generally higher than the rate of return required by other investors.
3. **Debentures:** Debentures are certificates issued by the company acknowledging the debt due by to its holders with or without a charge on the assets of the company. A fixed interest has to be paid regularly till the principal has been fully repaid by the company.
4. **Institutional Assistance:** The Government has set up certain special financial corporation with the object of stimulating industrial development in the country. These include IFC, SFC, ICICI, IDBI etc
5. **Public Deposits:** Public deposits are the another important source for the firms. Companies prefer public deposits because, these deposits carry lower rate of interest
6. **Lease Finance:** Lease financing involves the acquisition of the economic use of an asset through a contractual commitment to make periodic payments called lease rentals to the person who owns the asset. Thus this is a mode of financing to acquire the use of assets.
7. **Hire Purchase:** Assets involving huge amounts if other sources of long-term finance are too costly may be acquired through hire purchase.
8. **Government Assistance:** The government provides finance to companies in cash grants and other forms of direct assistance, as part of its policy of helping to develop the national economy, especially in high technology industries and in areas of high unemployment. Government subsidies and concessions are other modes of financing long-term requirement. Subject to the government regulations, subsidies and concessions are granted to business enterprises.
9. **Mortgage Bonds:** It is a written promise given by the company to the investor to repay a specified sum of money at a specified rate of interest at a specified time
10. **Venture capital:** Venture capital is the Money provided by investors to startup firms and small businesses with perceived long-term growth potential. This is a very important

source of funding for startups that do not have access to capital markets. It typically entails high risk for the investor, but it has the potential for above-average returns.

INTERNAL SOURCES

1. Retained Earnings : A company out of its profits, a certain percentage is retained that amount is reinvested into the business for its development. This is also known ploughing back of profits. Following are the main *advantages* of using Retained Earnings:

- a. Company *need not pay anything* on retained earnings, unlike debentures where a fixed rate of interest is to be paid.
- b. Retained earnings are *helpful in bearing shocks* of businesses. In adverse conditions, business may use its retained earnings.
- c. Retained earnings can be used to *invest in risky innovative projects*. As company is not bound to pay a fixed cost, it can take risks with it.
- d. Retained earnings help businesses *raise money from other sources*, for example bank etc. Banks consider it safe to give loans to businesses which has backup of retained earnings.

Following are the main *limitations* of using Retained Earnings:

- a. If a business retains more earnings, then its *shareholders* may become *dissatisfied*.
- b. Retained earnings as a source of finance is *available to only old companies*. New companies don't have enough retained earnings generally.
- c. If a company has huge retained earnings, its *management may tend to overspend*. This leads to misutilization of funds.
- d. There is *a fear of overcapitalization* of company if company has more retained earnings and is not able to invest it properly.

Thus retained earnings is a good source of finance that helps businesses in adverse situations. But it should be used carefully. Management should not become careless in spending money of retained earnings.

2. Provision for depreciation: Depreciation means decrease in the value of the asset due to wear and tear, lapse of time and accident. Provision for depreciation considered as one of the source of financing to business.

Meaning of Capital Structure

Capital Structure refers to the proportion of long-term sources of finance as used in business. There are various long-term sources of finance, such as equity shares, preference shares, debentures, long- term loans, retained earnings etc. A business can choose different ratios in which funds need to be raised from these sources in business. This proportion/ratio is called

capital structure. This is mainly expressed as Debt-Equity ratio, as Debt and Equity are two main components

Importance of Capital Structure

Deciding capital structure of a company means deciding which sources of finance will be used and how much amount will be raised from each source of finance. Following points highlight the importance of capital structure:

1. **Cost of Capital:** Cost of capital means the expenses that a business has to incur when it raises finance; for example, interest is the cost for raising loans. Different sources have different costs. Hence a capital structure will decide what is the overall cost of capital for a business.
2. **Decides the risk:** Some sources of finance are more-risky as compared to others. For example, loan is more-risky than equity, because business has to pay regular interest on loan, but not on equity. Hence capital structure also decides the risk borne by the company.
3. **Financial Flexibility:** Capital Structure decides the financial flexibility of the business. Use of debt/loan helps in providing financial flexibility, because business can return the money if it is not required. But equity share capital is not redeemed during the lifetime of business, hence there is lesser financial flexibility in case of equity shares.
4. **Tax Advantages:** Capital Structure of a company decides how much tax advantage a business will enjoy. Use of debt is preferred, because the business gets tax exemptions on interest paid on debt. But no tax advantage is there in case of equity share capital.
5. **Growth and Expansion:** A good capital structure helps business to arrange funds for future growth and expansion. If a business uses too much loan in its starting stage, it will be very difficult for business to pay interest and also business will find it very difficult to raise money for future expansion.
6. **Higher Value of Firm:** A good capital structure will enhance the returns to equity shareholders and it will also cause higher valuation of the firm.

Factors Influencing Capital Structure

Deciding capital structure means deciding which sources of finance will be used in business and in what proportion. A lot of factors influence this capital structure decision:

1. **Cost of Capital of Various Sources of Finance:** Different long-term sources have different costs of capital; for example, debt's cost is interest, dividend is share's cost

etc. Cost of debt is less than cost of equity mainly because there are tax exemptions for the company on interest paid on debt, but there is no exemption on payment of dividend. So from cost point of view, debt should be preferred.

2. Risk: Different sources of finance have different level of risks associated with them. Equity share capital is considered least risky, as no regular dividend payment is necessary. On the other hand, debt is very risky as the company has to pay regular fixed interest on that.
3. Size of the company: A big and reputed company can take finance from any source it wants. But for a small business, it is difficult to raise money. Even if small business gets loan, it has to pay higher rates of interests than a big business.
4. New vs Old Business: An old business can use retained earnings as a source of finance. But for a new business, retained earnings may not be available.
5. Cash-flow Position: If a company earns enough cash, only then it should go for debentures or long-term loans. If cashflow position is not stable, then it should go for equity and not debt.
6. Regular Profits: A company should use debentures or loans, only if it is earning profits on a regular basis. It is so because on debt company has to pay regular interests. If company's earnings are not stable, then it should use more equity, as the company is not bound to pay regular dividend.
7. Tax Considerations: The interest on debt is allowed as an exemption while calculating tax, but dividend is not. So from tax point of view, more debt should be used.
8. Flexibility: If a company wants flexible capital structure, it should use more debt. It is so because debt can be paid back if not needed at any time.
9. Industrial norms: While deciding its capital structure, a business should look at other companies' capital structure in the industry.
10. Market Conditions: If the interest rates are high in market, business should go for equity. If interest rates are lower in market, business should go for debt.

In short, business has to look for the advantages and disadvantages of every source and also study market conditions before making a choice of capital structure. This decision should be taken after due consideration because it is very difficult to change/reverse it.

Topics covered-

- a. Meaning and Importance of Cost of Capital
- b. Factors determining cost of capital
- c. Meaning and Importance of Capital Budgeting
- d. Methods of Appraisal: Traditional and Modern Methods
- e. Methods: Pay-back, Average Rate of Return, NPV, IRR, Profitability Index

Meaning of Cost of Capital

Cost of capital means the expenses related to a source of finance. We know that a business can raise funds from any source of finance, like equity shares, preference shares, debentures etc. Whenever it raises money, the investors want something in return. For example, if a business raises funds by issuing debentures, debenture-holders want interest. This minimum return expected by investors is known as cost of capital. Whenever a firm makes any investment, it must make sure that investment earns at least cost of capital. If a firm earns less than cost of capital, its market value will decrease.

Thus cost of capital can be defined in following way:

“Cost of capital is the rate of return expected by fund providers. It is the minimum rate of return that a firm must earn to maintain its market value.”

Cost of capital is also known as “cut-off rate”, “hurdle rate” and “minimum required rate of return”. Cost of capital can be of *two types*:

- a. Cost of capital of individual source of finance (For example, cost of debt, cost of equity etc.)
- b. Weighted Average Cost of Capital (Also called as combined cost of capital), which means overall cost of funds raised by business

Importance of Cost of Capital

Cost of Capital is an important aspect of business. Following points highlight the importance of cost of capital:

1. Helpful in taking Capital Budgeting Decisions: Capital Budgeting means decisions regarding investment in fixed assets of business. While taking these decisions, return on a project is compared with cost of capital. If a project earns more than cost of capital, only then it is accepted.
2. Helpful in taking financing decisions: Financing decision means deciding the capital

structure of the company, that is, selecting sources of finance from which funds are to be raised. While taking financing decisions, an attempt is made to minimize cost of capital. So, knowing about cost of capital is necessary for taking financing decisions.

3. Performance Measurement: A higher rate of return than cost of capital means value addition for the shareholders.
4. Strategic Planning: While taking strategic decisions, like expansion, mergers etc., cost of capital is compared with expected returns from these decisions.
5. Helpful in deciding the risk of firm: A company with high cost of capital is considered risky for investment.

Factors Determining Cost of Capital

1. Internal Factors: These are the factors that are company-specific, which means these are related to an individual company. Following are the main internal factors that affect cost of capital:
 - a. Business Risk: If a business has higher risk, its cost of capital would be high, because investors will ask for more returns. On the other hand, if a business is less risky, its cost of capital would be low.
 - b. Financial Risk: If a firm is using more debt, its financial risk will be more. If there is more financial risk, then the investors will ask for more returns and therefore, its cost of capital would be high.
 - c. Stability of earnings: If a business is earning stable profits, then investors will feel secure and will demand less, therefore cost of capital would be low in such cases. But if a business has irregular earnings, its cost of capital would be high.
 - d. Growth Prospectus: If a business has strong growth prospects, then its cost of capital would be less, as investors will be ready to invest in such firms easily.
 - e. Operating efficiency of management: A good management reduces the risks for investors and therefore, cost of capital is low in such cases.
2. External Factors: These factors are related to market and affect all firms in general. Following are the main external factors that affect the cost of capital:
 - a. Interest Rates: If interest rates are high in market, then cost of debt will go up. If interest rates are low in market, then cost of debt will go down.
 - b. Market Conditions: In case of volatile market, the cost of capital is high as investors are not willing to invest much due to increased risk. In case of stable markets, cost

of capital is generally lower.

- c. Tax Rates: Higher tax rates lower the cost of debt. It is so because the interest paid on debt is tax-deductible.
- d. Inflation: In case of high inflation, investors will want more returns and therefore, the cost of capital becomes high.
- e. Type of Industry: Certain industries are more volatile in nature, such as IT based companies, so, their cost of capital is higher. Industries with more stability have lower rates of cost of capital.

MEANING OF CAPITAL BUDGETING

As we have discussed earlier, Financial Management involves three decisions: Investment Decision, Financing Decision and Dividend Decision. Investment decision means deciding how much amount should be invested and in which assets. There are two main types of assets: Fixed Assets and Current Assets. Fixed Assets are those assets which are meant for long-term use in the business and which are not meant for resale. Examples of Fixed assets are: Land, Building, Machinery, Furniture etc. Current Assets are those assets which are expected to be converted into cash in a period of one year or less. Examples of Current Assets: Cash, Bank, Debtors, Stock, Prepaid Expenses, Short-term investment. Since there are two types of assets, so investment decision is also divided into two parts: Capital Budgeting and Working Capital Management. Capital Budgeting means deciding in which fixed assets the business should invest its money. Working Capital Management means deciding in which current assets the business should invest its money.

Thus, Capital Budgeting is a process of deciding how much money should be invested in fixed assets and which fixed assets should be chosen for investment. Capital Budgeting decisions may be of two types:

1. Mutually Exclusive Decisions: Where one option is to be chosen out of two or more. For example, if a company wants to buy a xerox machine and there are three brands available, namely X, Y and Z. The company needs to choose only one out of these three brands. This decision is called mutually exclusive decision.
2. Independent decisions: In these types of decisions, companies evaluate a single project and decides whether money should be invested in it or not.

Importance of Capital Budgeting

Following points highlight the reasons why capital budgeting decisions are important:

1. Huge amount of money: Capital Budgeting decisions involve huge amount of money because fixed assets are very costly. This makes these decisions very difficult.
2. Time Period: Capital Budgeting decisions are related to fixed assets which are to be used in business for many years. Thus these decisions affect the long-term profitability of the business. If these decisions are taken wrong, then it will affect performance of business for many years.
3. Irreversible in nature: Capital Budgeting decisions are irreversible in nature. Once taken, it is very difficult to change them. For example, if one machine has been purchased and if business wants to reverse its decision, it will have to sell it and in most of the cases, business will have to bear huge loss.
4. Future Production Capacity: Capital Budgeting decisions are related to fixed assets and these assets would decide in future the production capacity and scale of the business.
5. Level of technology: Capital Budgeting Decisions are related to the fixed assets of the organization. These assets showcase the level of technology a business is using.

METHODS OF CAPITAL BUDGETING

In capital budgeting decisions, a finance manager decides in which assets a business should invest its money in. In case of mutually exclusive decisions, there are two or more alternatives, then a manager needs to compare them and select the best out of them. In case of independent project, one project is evaluated and then compared with some pre-decided criteria, then the decision is made. Following chart highlights the main methods/techniques used in taking capital budgeting decisions:

1. Methods Based on Accounting Profits: This method will evaluate a project based on accounting profits. Under this method, ARR method is included.

ARR Method: ARR stands for Accounting Rate of Return. For calculating ARR, following formula is used:

$$ARR = \frac{\text{Average Profits}}{\text{Average Investment}} * 100$$

For computing average profits, we take total profits of all years and divide it by number of years.

Total Profits

$$= \frac{\text{Average Profits}}{\text{Number of Years}}$$

For computing average investment, we add initial investment and scrap/salvage value and divide the sum by 2.

$$= \frac{\text{Average Investment} \quad \frac{\text{Initial Investment} + \text{Scrap Value}}{2}}$$

- Merits of ARR Method:
 - Easy Calculation, simple to understand and use
 - Total benefits of projects are taken into consideration
- Demerits of ARR Methods:
 - Deficiency of use of accounting income instead of cashflows
 - Doesn't consider size of investment (e.g. two projects with same ARR, but have different initial costs)

2. Methods based on cash flow

- a. **Payback Period Method:** Payback period means time taken by a project to recover its investment. For example, if a machine costs Rs. 1,00,000 and is expected to give cash inflows of Rs. 40,000, Rs. 60,000 and Rs. 20,000 in 3 years; then its payback period will be 2 years, as in two years, it will recover its investment of Rs. 1,00,000.

For comparing two projects under this method, the project with lower payback period is preferred. It is so because less payback period means lesser time taken by project to recover its investment.

Advantages of Payback period method:

1. It is simple method.
2. It is practical and used quite a lot.
3. It uses cash inflows and outflows.

Disadvantages of Payback Period Method:

1. It doesn't take into account present value of cashflows.
2. It doesn't consider the cash inflows after the payback period.

B.) **Net Present Value Method:** In this method, NPV of a project is computed.

Net Present Value is the excess of Present Value of Cash-inflows over Present Value of Cash-outflows. It is computed with the help of following formula:

$$\text{NPV} = \text{PV of Cash-inflows} - \text{PV of Cash-outflows}$$

If Net Present Value of a project is positive, business should invest money in it. If Net Present Value is negative, then that project should not be undertaken. If two projects are compared, then project with higher NPV is selected.

Merits of NPV Method:

4. Explicitly recognizes time value of money.
5. Considers total benefits of a project (unlike payback period method)
6. Discount rate may be changed to accommodate time and risk dimension.
7. In tune with goal of shareholders' wealth maximization

Demerits of NPV Method:

1. Difficult to calculate.
2. Difficult to decide discount rate.
3. Doesn't consider initial outlay. (Two projects with same NPV are ranked same, despite different levels of initial outlay.)
4. Not very reliable when life-span of two projects compared are different. (Two projects with same NPV are ranked at par, but one with shorter lifespan should be adopted, other things being constant.)

b. Profitability Index Method (PI Method)

Under this method, we compute PI of a project with the help of following formula:

$$PI = \text{PV of cash inflows} / \text{PV of cash Outflows}$$

If PI is more than one, then this project should be selected. But if PI is less than one, then the project should be rejected. If two projects are to be compared, then the project with higher PI should be selected.

MERITS OF PI METHOD

1. Considers time value of money.
2. Considers totality of benefits
3. Better method in case of comparing two projects with different outlays.

DEMERITS OF PI METHOD

1. Difficult calculations.
2. Difficult to decide discount rate.

UNIT V: DIVIDEND DECISIONS

Topics covered-

- a. Relevance and Irrelevance of Dividend Decisions
- b. Determinants of dividend policy
- c. Dividend policy in practice
- d. Types of Dividends: Cash and Stock dividend, their merits and demerits

Introduction

Dividend is that part of profits of a company which is distributed among shareholders. The profits of the company (after paying all its dues) is either distributed to shareholders as a return on their investment or is retained in business. The part which is distributed among shareholders is called dividend. The part which is reinvested in business is known as retained earnings.

Types of Dividends

Dividends Based on Type of Shares: There are two types of shares: Equity shares and Preference shares. Accordingly, there are two types of dividends: Equity dividend and Preference dividend. Rate of preference dividend is fixed, but rate of equity dividend is not fixed. It means that dividend on equity shares is not paid at a pre-decided rate. It may also happen that no dividend is paid to equity shareholders even if a company is earning profits, as company may decide to reinvest all its earnings.

Dividends Based on Mode of Payment: Depending upon the mode of payment, dividends can be of following types:

- a. Cash Dividend: This dividend is paid in form of cash. Hence, cash reserves of the company reduces and also the stock price.
- b. Stock Dividend: When a company doesn't have enough cash to pay dividend, then it may issue additional shares to existing shareholders. This is known as stock dividend. The overall value of the firm doesn't change, but number of shares increases.
- c. Property Dividend: When dividend is paid in form of some property, it is known as property dividend. For example, a watch manufacturing company may offer watches in form of dividend.
- d. Scrip Dividend: In this case, a company issues a promissory note to shareholders. Through this note, company promises to pay dividend at a later date. It is usually

done when the company doesn't have enough cash to pay dividend.

- e. Composite Dividend: When dividend is paid in more than one form, it is known as composite dividend. For example, a company pays cash dividend along with property dividend, then this is known as composite dividend.

Dividends Based on time of payment: Depending upon when a dividend is being paid, following are the main types of dividends:

- a. Interim Dividend: A dividend that is paid during the financial year, before the closing of the year. This dividend is usually paid based on profits of a portion of year. It shows good financial position of the company.
- b. Annual Dividend: This dividend is paid at the end of financial year, based on annual profits earned by the company. It is declared at company's Annual General Meeting.
- c. Special Dividend: The dividend is paid at certain special occasion, for example, company may declare dividend at 25th anniversary of foundation etc. Special dividends may also be paid when a company earns some extra-ordinary profits.

Cash Dividend and Stock Dividend: Merits and Demerits

Cash Dividend

Cash Dividend means dividend paid in form of cash. It is most prevalent form of dividend.

Merits of Cash Dividend

- a. It provides immediate income to shareholders and therefore shareholders prefer it.
- b. Cash dividend is more certain and predictable, offering stability to shareholders.
- c. Regular cash dividend is an indicator of sound financial health of company.
- d. In some cases, cash dividend attracts lower rates of tax for the company.

Demerits of Cash Dividend

- a. It causes cash outflows and hence reduces cash reserves of the company.
- b. If a company pays cash dividend, there may be an indication that company has no growth prospects for future.

Stock Dividend

When a company doesn't have enough cash to pay dividend, then it may issue additional shares to existing shareholders. This is known as stock dividend.

Merits of Stock Dividend

- a. Since company has to pay no cash for stock dividend, its cash reserves remain intact.
- b. Shareholders get additional shares of the company and gets benefitted if the company performs good in long-run.
- c. If a company pays stock dividend in place of cash dividend, then it signals that the company has profitable investment opportunities where it wants to invest. It shows sound future growth prospects of the company.
- d. Overall value of firm doesn't decrease because of this form of dividend

Demerits of Stock Dividend

- a. Sometimes, shareholders don't like stock dividend, as they want immediate and cash income from shares.
- b. If a company pays stock dividend, it may signal lack of sufficient cash for the company. In such cases, creditor may become suspicious.
- c. Stock dividend doesn't provide immediate income to shareholders. They get the returns only in long-run when company performs good.

Meaning and Types of Dividend Policy

Dividend Policy refers to the broad guidelines based on which the company's management decides how much dividend will be paid every year.

The dividend policy can be of following types-

1. Regular Dividend Policy: When a company follows this policy, then it pays dividend at regular intervals. It may be paid quarterly, half-yearly or annually. The companies which follow such policies have stable income.
2. Stable Dividend Policy: A company following this policy maintains stability in its dividend policy. Stable Dividend Policy may be of following three types:
 - a. Constant Dividend Per Share: A company following this policy will pay constant dividend on every share, for example, company may decide to pay Rs. 5 per share dividend. It will pay same dividend every year.
 - b. Constant Payout Ratio: A company following this policy maintains constant payout ratio. Payout ratio means the percentage of profits that a company pays to its

shareholders. So, if a company has decided 25% payout ratio, then under this policy, it will pay 25% of profits as dividend every year. Whatever profits it earns in any year, it will distribute 25% of that as dividend.

- c. **Stable Rupee Dividend Plus Extra Dividend:** In this case, a company pays constant dividend per share and in addition to that, also pays extra dividend in the year of extra profits.
- 3. **Irregular Dividend Policy:** Under this policy, a company pays dividend in some years and doesn't pay dividend in some years. This policy shows lack of consistency in company's approach and is not a very good signal for company's growth.
- 4. **No Dividend Policy:** A company following this policy doesn't pay any dividend, rather invests all its profits in business again. Such type of policy is followed by the companies in initial years of their formation, because company needs more finance then.

Relevance and Irrelevance of Dividend Decisions

There are two different views on the question whether dividend affects the market value of the firm or not. According to one view, dividend decision is important as it affects the market value of the firm. This point of view is known as "Relevance Theories." Walter and Gordon are two important proponents of relevance theories. Another view states that dividend decision doesn't affect the market value of the firm. According to this view, even if a company pays no dividend, its market value will remain same. This point of view is known as "Irrelevance Theories." Modigilani and Miller are important proponents of this view.

Walter's Model: This model supports the relevance theory. It states that dividend decisions have an important role in deciding a firm's value. According to this model, to decide the optimum dividend, cost of equity (k_e) should be compared with rate of return a company is earning through its projects (r). There may be three cases:

- a. $k_e > r$ (All profits should be paid as dividend)
- b. $k_e < r$ (All profits should be retained in business)
- c. $k_e = r$ (Whether a company pays dividend or not, its value will not change.)

Thus, according to this model, the amount should be kept with whoever earns more. If

company earns more, then it should retain all profits. If shareholders can earn more, then company should distribute all profits to them.

Gordon's Model: This model also supports relevance theory i.e. the dividend decisions have an impact on market value of the firm. According to this model, the shareholders always prefer current dividend because future is uncertain. It is in line with the maxim "One bird in hand is better than two in the bush." It states that if a company will retain more profits and distribute less dividend, then investors will be ready to pay less price for its shares. On the other hand, if a company will retain less profits and distribute more dividend, then investors will be ready to pay higher price for its shares. Thus, more dividends mean company gets better price and vice-versa.

MM Approach: This approach supports the irrelevance theory. In other words, it states that the dividend decisions have no impact on market value of the firm. This approach assumes that markets are perfect. It argues that since markets are perfect, it is not possible to beat the market. Hence, in any condition, an investor can earn same amount with a given level of debt. The market value of two firms (one distributing dividend and another not paying dividends) will always be same. So, dividend decisions will be irrelevant.

Determinants of Dividend Policy/Factors Affecting Dividend Policy

There are a lot of factors that affect how much a company will pay as a dividend. Following are the main determinants of dividend policy:

- a. **Profitability position:** If a company is earning good profits, it will pay regular dividends. On the other hand, if a company is not earning enough profits, it will not be able to pay regular dividends, because it will have to save for difficult days.
- b. **Cash-flow position:** If a company is having sound cash-flow position, it will be able to pay cash dividends. Otherwise, it will not be possible for a company to pay dividends.
- c. **Future requirements:** If a business needs money for future investment, then it will be reinvesting it in business and therefore distribution of dividend will be less. But if a business doesn't have plans for future growth, then it may distribute more of its earnings as dividend.
- d. **Industry norms:** Some industries pay regular dividends, for example, most of the

PSUs (Public Sector Undertakings) pay regular dividends in India. So the company decides its dividend policy keeping in mind the practice followed by other companies in the same industry.

- e. Management's Attitude: If a company's management is conservative, then it may prefer to save more and pay lesser dividends. On the other hand, if management of a company is aggressive, it will pay dividends at a higher rate.
- f. Legal compliance: Every company has to follow legal guidelines while deciding its dividend policy. For example, a company can not pay dividend out of capital.
- g. Shareholders Expectations: Shareholders are the real owners of the company. If shareholders of a company expect regular dividend, then the company usually follows such policy. If shareholders are not interested in dividends but are rather interested in value generation by reinvesting, then the company will pay lesser dividends.

Past Dividend Rates: A company usually follows consistent dividend policy. So the rate of present dividend depends on the previous years' dividend as well.