UNIT-1

FINANCIAL MANAGEMENT OVERVIEW

INTRODUCTION:

Finance is the foundational layer on which businesses are setup and run. Access to finances can enable a firm to expand and grow. Similarly, lack of funding can lead to restrained operations and in extreme cases cause a financial collapse of the business altogether. Irrespective of the nature of business, finance is a critical resource which needs to be managed efficiently for a smooth and successful running of companies and markets. Financial management is the process by which a firm creates and implements a financial system which enables it to achieve its goals and drive shareholder value via optimum resource utilization and deployment in various asset classes.

DEFINITION

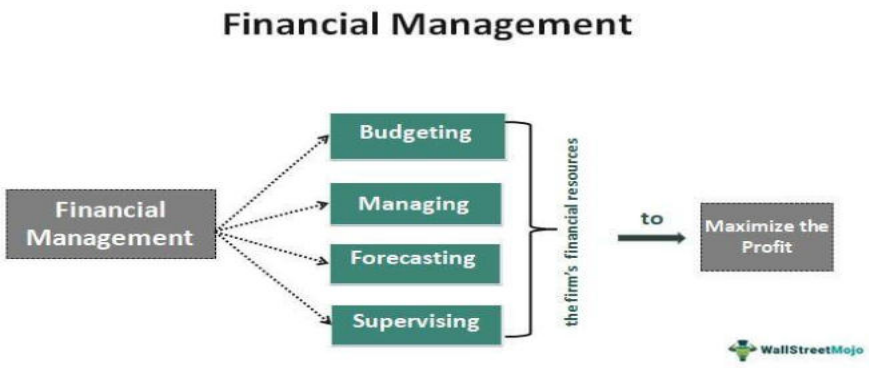
Finance is the management of monetary affairs of a company. It includes determining what has to be paid for and when, raising the money on the best terms available and diverting the available funds to the best uses.‖—-Paul G. Husings

―Finance has to be co-related with production, marketing and accounting functions of organization in order to reduce or avoid the wastage of funds.‖ - Charles Gestenberg.

FINANCIAL MANAGEMENT:

According to traditional books, Financial management is all about strategic planning, organizing, directing, and controlling an organization's financial resources to achieve its objectives effectively. In short, Financial management is managing the organization's finances in such a way that it stabilizes the organization with consistent growth & profitability. It involves making judicious financial decisions that align with the company's goals, ensuring optimal utilization of funds and enhancing overall financial well-being. Here are some of the objectives involved:

- Maintaining enough supply of funds for the organisation
- Ensuring shareholders of the organisation get good returns on their investment
- Optimum and efficient utilisation of funds
- Creating real and safe investment opportunities



Financial management is also made up of certain elements. These include:

Financial planning: This is the process of calculating the amount of capital that is required by an organisation and then determining its allocation. A financial plan includes certain key objectives which are:

- Determining the amount of capital required
- Determining the capital organisation and structure
- Framing of the organisation's financial policies and regulations

Financial control: This is one of the key activities in financial management. Its main role is to assess whether an organisation is meeting its objectives or not. Financial control answers the following questions:

- Are the organisation's assets being used competently?
- Are the organisation's assets secure?
- Is management acting in the best financial interests of the organisation and the key stakeholders?

Financial decision-making: This involves investment and financing with regard to the organisation. This department makes decisions about how the organisation should raise finances, whether they should sell new shares, or how the profit should be distributed.

Definition of Financial Management

(1) Financial management deals with how the corporations obtain the funds and how it uses them. -Hoagland
(2) Financial Management is the application of planning and control functions to the finance function. -Archer and Ambrosio
(3) Financial management may be considered to be the management of the finance function‖. -Raymond Chambers
(4) Financial management is the area of business management devoted to a judicious use of capital and a careful selection of sources of capital in order to enable abusiness firm to move in the direction of reaching its goals. —J.F. Bradley

Nature of Financial Management

1. Perpetual Process

Till the company exists, Financial management is going to exist. It is not a one-time activity; instead, it's a perpetual or never-ending process. It is evolved and evaluated on a consistent basis which matches the trending technology, resources, market conditions and tools. This adaptability is crucial for steering a company through economic uncertainties and market fluctuations.

2. Interdisciplinary Approach

Financial management takes a lot of factors and disciplines such as accounting, economics, statistics, and mathematics into consideration while managing the organization's finances.

Financial managers need to integrate knowledge from these diverse fields to make informed decisions that impact the organization's financial health positively.

3. Goal-oriented

Financial management is all about managing the financial goals of the company. The primary objective of financial management is to maximize shareholder wealth. This goal underpins all financial decisions, steering them towards actions that enhance the company's value and ensure sustained profitability.

4. Risk and Return Trade-off

Financial management involves a delicate balance between risk and return. The sign of sound financial management is the maximization of returns with less risk. There are multiple decisions like investment choices, financing options, and dividend policies that require an assessment of potential risks against the expected returns. Striking the right balance is essential for long-term sustainability. A manager or authorized person has to ensure the right balance between risk and return which will benefit the organization and its stakeholders.

5. Utilization of Funds

Managing the financial resources is a tough task and efficient utilization of funds is a key of financial management. It involves allocating resources optimally to ensure the organization's operational efficiency, growth, and overall competitiveness in the market. Managing the flow of funds plays a big role in determining the success of the business. To ensure the right flow, monitoring on a regular basis needs to be done.

Scope of Financial Management

1. Investment Decisions

Managing funds is the key to successful financial management. Determining where and how to invest funds is an important aspect of financial management. This includes evaluating various investment opportunities, estimating returns, and assessing risks to make informed choices that align with the organization's goals.

2. Financial Planning

Financial planning is crucial in defining the path to a company's financial success. This involves budgeting, forecasting, and strategic planning to ensure the availability of funds when needed. More importantly, financial planning gives authorized people a process to track and measure the success of the business.

3. Capital Structure Management

Capital structure management is about finding the right balance between debt and equity to fund a company's activities. The composition of a company's capital, known as its capital structure, is a crucial aspect of financial management. The two primary components of capital structure are Debt

and equity capital. The sound capital structure management is about focusing on cost of capital, risk management, maximizing shareholder value, financial flexibility, etc.

4. Working Capital Management

Working capital management is all about monitoring & controlling short-term assets & liabilities ensuring smooth day-to-day operations of a business effectively. Financial managers need to strike a balance between current assets and liabilities to ensure the smooth flow of business activities. The key objectives of Working capital management include Managing liquidity, inventory, accounts receivable, accounts payable, cash flow forecasting, etc. Effective working capital management contributes to the overall financial health and stability of a business.

5. Dividend Decisions

Determining the distribution of profits through dividends is another aspect of financial management. Dividend decisions are about an organization's choices regarding the distribution of profits to its shareholders in the form of dividends. There are certain factors involved while making dividend decisions like profitability, cash flow, investment opportunities, tax, etc.

6. Risk Management

The primary goal of risk management is to enhance the likelihood of success in achieving the organization's goals and objectives while minimizing the impact of potential adverse events. Financial managers must identify, assess, monitor and mitigate various financial risks, including market risks, credit risks, and operational risks.

Objectives of Financial Management

1. Compliant with Regulations

One of the important objectives of financial management is to ensure that the **business becomes compliant with regulations.** This ensures that the business can operate without any legal issues. Other compliances will ensure that the business is properly operational and does not have any loopholes. It helps in building trust among customers.

2. Profit Maximization

Another important objective of financial management for any business is maximizing profit. Funds are managed in a way so that earnings per share (EPS) or profits are maximized for the maximum results. To achieve this objective, such activities should be undertaken that help in increasing profits. Those actions that decrease profits are avoided. The operational concept of profitability is applied, which aims at profit maximization.

3. Fund Mobilization

Proper mobilization refers to the effective gathering and allocation of funds within a business. It includes sourcing capital in an optimized manner and deploying these resources effectively towards projects. It is meant to ensure that an organization has enough funds to meet requirements

such as maintaining operations, investing in new projects and maintaining operations. Overall, the aim is to maintain the financial health of the business while ensuring its sustainability,

4. Capital Assessment

Another objective of financial management is cost and capital evaluation. This includes the evaluation of fixed assets and current assets, marketing costs, buffer capital, etc. Cost of capital represents the minimum acceptable rate of recoverability of investment projects while considering account risk and uncertainty.

5. Formulation of Policies

Through financial management, companies work at formulating policies to smoothly run the business. This includes framing policies that govern the lending and borrowing process as well as cash control.

6. Liquidity within the company

Financial management aims to monitor the liquidity within the company. For this, **management of cash flow is also performed.** This ensures that there is neither an underflow nor an overflow of cash within the organization. A regulated cash flow ensures that the business is financially stable with sufficient liquidity for the business to operate.

7. Building capital structure

To maintain a balance among different sources of capital, **it is important to build a capital structure.** It is the combination of equity and debt financing that companies use for financing their operations. This structure determines business-related financial decisions such as the short-term and long-term debt-equity ratio.

8. Utilization of resources

One of the crucial objectives of financial management is the **optimization of financial resources**. Experts devise methodologies to optimize these resources while minimizing their wastage. Finance managers manage funds such as debentures, bonds, and shares. Based on financial requirements, the finance manager allocates funds to these sources to reap the maximum benefit.

9. Contingency Plan

Through financial management, **organizations can survive even in critical financial crises.** Experts work on building contingency plan that estimates risks associated with the future. After the assessment and analysis, they build a contingency plan to combat financial crises. The company can create financial reserves by planning an optimal dividend payout policy. They can also save their profits in reserves for emergency situations.

10. Identifying Profitable Investments

Financial management also aims at identifying investments that are suitable for the company's business model. Based on proper market study, financial experts identify and suggest opportunities where companies can start investing to reap the maximum ROI.

11. Allocation of Funds

Another objective of financial management is **fund allocation**. Financial managers wisely allocate funds to various business activities and operations. This ensures that each operation is sufficiently funded for the foreseeable future. For the proper allocation of funds, managers perform analysis and go through financial statements and historical records of the company.

12. Risk Management

For any organization's healthy survival and smooth business operations, **it is important to assess risk.** Through risk management, businesses can identify, and contain the threats to their capital, profits, and revenue since any unforeseen event can crumple an organization's financial situation. To avoid such unfortunate situations, organizations must use resources for minimizing, monitoring, and controlling the impact of negative events. This is why a systematic and integrated approach to risk management is important.

13. Decision Making

One of the objectives of financial management is decision-making. For this several steps are undertaken including building **different financial scenarios and identifying potential financial risks that may hamper the final business**. Say, a financial condition has arisen where there has been an increase in the interest rate that may impact your debt structure. Another scenario may arise where there are positive opportunities that may occur from economic changes objective.

14. Business Survival

Business survival is an **important objective of financial management** that focuses on keeping a company operating through difficult times rather than pursuing growth or high profits. This objective is important when businesses face challenging conditions like economic downturns, new competition, or unexpected problems. For a business to survive, it must generate enough money to cover basic operating costs including rent, wages, and supplies, while maintaining sufficient cash flow to pay bills and debts on time. Companies focusing on survival typically take practical steps such as reducing non-essential expenses, concentrating on their most profitable core products or services, and carefully managing their cash. They also work to maintain good relationships with key suppliers and customers while keeping essential staff employed.

15. Marketing Activities Optimization

Optimizing marketing activities as a financial management objective focuses on **getting the best possible results from marketing spending while keeping costs under control**. This means carefully tracking how much money goes into marketing and measuring what the business gets back from these investments. Companies achieve this by analyzing data from their marketing campaigns to see which ones bring in the most customers and sales for the money spent. They might look at metrics like cost per customer acquired, return on ad spending, and conversion rates from different marketing channels.

FUNCTIONS OF FINANCIAL MANAGEMENT

Financial management functions are an essential requirement to start any business. Regardless of the size of the business, objectives remain constant. To handle financial resources effectively, financial management is crucial. Financial management functions ensure that a business has access to the necessary revenue when needed. The functions of a financial manager include everything from getting money to using it effectively.

9 Major Functions of Financial Management

Listing down the top 9 financial management functions can help you take a deeper look into the functions of a financial manager. And, if you are interested, you can opt for financial management courses and certifications.

1. Financial Planning and Forecasting

Financial management, refers to the procurement of funds and effectively managing and utilising the same in business, While the term "financial management Planning & forecasting" refers to the application of management principles to financial resources, in basic terms, it is

- Planning
- Organising
- Directing
- Controlling

2. Cash Management

The primary function of financial manager is to determine the revenue a company will need to reach its goals. When determining how much capital a company needs, the role of a finance manager includes estimating the size of the business, predicting profitability, and understanding company policies. The manager must also know how to measure financial risk management to secure the business from losses.

3. Determining the Capital Structure

When the capital requirement estimation is complete, one of the other major financial management functions is deciding on the capital composition. Both long-term and short-term debt equity research and analysis are involved in this function. It will mostly depend on the amount of equity capital that a company already has and the additional revenue required from other sources. The structure must be decided upon after assessing the necessary capital.

4. Funding Sources

Identifying the source of the capital is one of the next financial management functions. In order to raise capital in exchange for equity, the company may choose to contact investors, take bank loans, or hold an initial public offering (IPO). The advantages and restrictions of each funding source are taken into consideration while choosing and ranking them.

5. Forecasting Cash Flows

Estimating the upcoming expenses is part of the cash flow forecasting process. A cash flow prediction is an essential tool for your company because it will let you know whether you'll have enough money to run or grow the enterprise. It will also let you know when the company is losing more money than it is making. The funding sources may be internal or external.

6. Income Distribution

The financial manager functions include making the judgement regarding net revenues. This is possible in two areas of an organization's financial management functions. First, when a dividend is declared, the rate of dividends and, if applicable, bonuses are also determined.

7. Investing the Business Capital

Making decisions on how to distribute money to successful ventures is another one of the functions of financial management. For each investment, the financial manager must be aware of the financial management risk and projected return. Also, the investment strategies must be designed to maximise profit potential and minimise capital loss. Financial management functions are required to invest funds in viable businesses to ensure investment protection and consistent returns on investment.

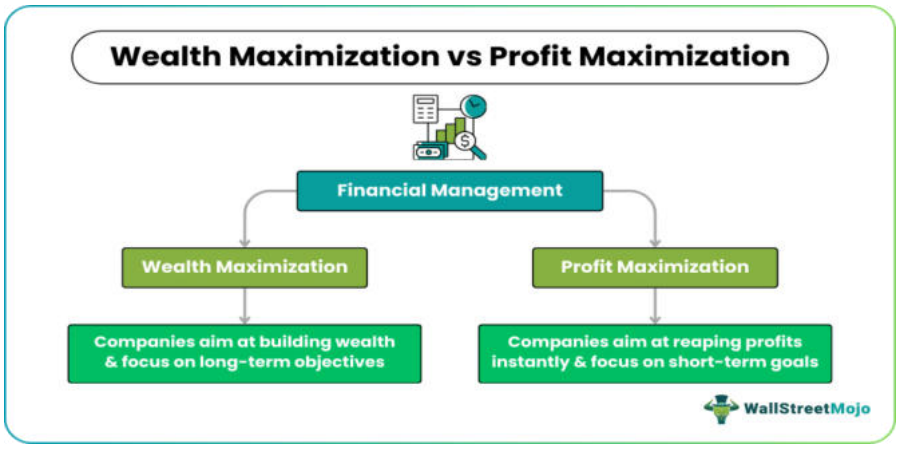
8. Financial Command

The finance manager must develop tactics and ways to work on financial control of funds in addition to developing strategies to raise, allocate, and spend funds. A number of strategies can be used to accomplish this when it comes to financial management functions, including ratio analysis, financial forecasting, pricing, cost control, and others.

9. Pricing & Price Control

Many sizable businesses have thorough cost-accounting systems in place to keep track of expenditures related to financial management functions. Moreover, systems are made to emphasise statistically significant information on tasks and activities that will be displayed on a monitor. Financial management functions may offer insight into variations in spending at various manufacturing levels and the revenue margins required to run the firm successfully.

PROFIT MAXIMISATION AND WEALTH MAXIMISATION



What Is Profit Maximization?

The profit earned by a company is given by subtracting the total cost from the total revenue it generates. So the two main ways a company can increase profit is by either increasing the output or by decreasing the input. Profit Maximization is a strategy that helps a company earn the maximum possible revenue at minimum costs. A company that wants to maximise its profits will make the amount of product where the cost of making one more unit (marginal cost) is the same as the revenue from selling one more unit (marginal revenue). This is done by implementing different strategies, like deciding the optimal price for goods or services, changing the production process to reduce costs, using cheaper materials and labour, cutting down overhead costs, improving sales techniques to increase sales, and managing resources efficiently.

According to this concept, actions that increase the firm's profit are undertaken while those that decrease profit are avoided. The profit can be maximised either by increasing output for a given set of scarce input or by reducing the cost of production for a given output. The modern economics states that the profit maximisation is nothing but a criterion for economic efficiency as profits provide a yardstick by which economic performances can be judged under condition of perfect competition. Besides, under perfect competition, profit maximisation behaviour by firms leads to an efficient allocation of resources with maximum social welfare. Since, the capital is a scarce material, the financial manager should use these capital funds in the most efficient manner for achieving the profit maximisation. It is, therefore, argued that profitability maximisation should serve as the basic criterion for the ultimate financial management decisions.

The profit maximisation criterion has, however, been questioned and criticised on the following grounds:

- its vagueness
- it ignores the timing of benefits
- it ignores risk

One practical difficulty with profit maximisation criterion is that the term profit is vague and ambiguous as it is amenable to different interpretations, like, profit before tax or after tax, total profit or rate of return, etc. If profit maximisation is taken to be the objective, the problem arises,

which of these variants of profit to be maximised? Hence, a vague concept of profit cannot form the basis of operation for financial management.

A more important technical objection to profit maximisation is that it ignores the differences in the time pattern of the cash inflows from investment proposals. In other words, it does not recognise the distinction between the returns in different periods of time and treat them at a par which is not true in real world as the benefits in earlier years should be valued more than the benefits received in the subsequent years.

Example – Profit Maximisation

- Suppose a company wants to maximise its profits. It can do so in many ways, such as:
- It can increase the price of goods or services to boost profit margins. The pricing strategy should always take into account that the market can bear the higher prices without considerable loss of sales volume.
- The company can reduce production costs by using cheaper raw materials, labour, and also negotiate better deals with suppliers.
- It can increase sales by entering new markets and focusing on marketing.
- The company can move to areas with cheaper rents or use machinery that requires less maintenance.
- It can also explore new ways of reaching customers, such as online marketing, e-commerce platforms, and social media engagement.

Characteristics of Profit Maximization:

Short-Term Profit: Profit maximization maximizes a company's profits in the shortest time possible.

Objective: The objective is to maximize the difference between the revenue of a company, which is sales, and its costs, thereby maximizing the profits.

Decision Making: Decisions are taken based on how they will impact profits in the short term, without much concern for long-term effects.

Risk: This strategy sometimes relates to more prudent but risky decisions, overemphasizing short-term profits that hurt the business long-term.

Shareholder Focus: Shareholders' interests are considered when raising dividends or stock prices as quickly as possible.

No Consideration for Social Welfare: Profit maximization often ignores business decisions' social and ecological consequences.

What Is Wealth Maximization?

Compared to profit maximisation, wealth maximisation is a modern approach. It doesn’t just focus on short-term profits but rather, aims to make various stakeholders of the company wealthier in the long term by aiming to increase the overall value of a company through stock market value (earnings per share and capitalization rate). Wealth Maximization aims to create lasting value. It

focuses on much broader factors, such as the quality of goods and services, the company's reputation, customer satisfaction, innovation, and strategies that promote sustainable growth.

Example – Wealth Maximisation

- If a company wants to focus on making its shareholders wealthier, it can follow these strategies:
- The company can invest in technology that promises sustainable long-term returns rather than short-term gains, and expand its research and development.
- It can improve the quality of its goods and services, and also its customer services. This focus on client satisfaction increases a company's reputation and builds a strong and loyal customer base.
- Another strategy that can improve a company's reputation is adopting environmentally and socially responsible practices.
- The company can invest in training its employees to improve their skills and productivity. Well-trained employees are more effective, so the operational efficiency of the company will increase.

Characteristics of Wealth Maximization:

Focus on Long-Term Value: Wealth maximization is more concerned with increasing the firm's long-term value, keeping profits and future growth potential in view.

Objective: The objective is to maximize shareholder wealth, reflected by the market value of shares, dividends, and future potential.

Decision Making: Decisions are made with a long-term view, considering future cash flows, investments, and sustainability of growth.

Risk: The approach towards risk in wealth maximization tends to be balanced. Wealth maximization shuns the short-term gain that can compromise stability in the future.

Shareholder Focus: Shareholder interests are still on center stage, but wealth maximization would look at the long-run increase in shareholder value rather than the short-run profits.

Difference Between Profit Maximization and Wealth Maximization

Profit maximisation and wealth maximisation are two major objectives of financial management. While profit maximisation strategies focus on generating profit in the short term, wealth maximisation strategies aim to increase the share value of the company for the shareholders over the long term. Let's learn the difference between profit maximization vs wealth maximization in financial management, and what each strategy means for a company's success.

Profit maximization focuses on boosting a company's earnings, while wealth maximization is geared toward enhancing the overall value of the entity. While profit maximization is often seen as a primary goal, as it reflects operational efficiency, wealth maximization seeks to increase the value for stakeholders, ensuring long-term growth and sustainability.

Basis	Profit Maximization	Wealth Maximization
Goal	The main goal of profit maximisation is to maximise a company's profit by decreasing costs or increasing revenue. It prioritises cutting costs and immediate profit generation.	The main objective is to maximise the wealth of all shareholders. It encourages strategic investments that may not pay off immediately, but will in the future.
Time Horizon	Generally considered a short-term strategy.	Focuses on the long term.
Time Value of Money	Does not consider the time value of money.	Considers the time value of money.
Sustainability	A company looking to maximise profits may not always make sustainable decisions.	Uses sustainable practices.
Flexibility	Not as flexible because the company may not be able to adapt to short-term market conditions.	Allows easy readjustments to strategies based on the company's long-term goals.
Risk	It can be risky to earn immediate profits, so the company must have a high-risk tolerance.	The strategies involved tend to be not very risky as the company seeks long-term sustainability.
ESG	Environmental, social and governance factors may not be prioritised.	ESG can improve a company's reputation, ensure regulatory compliance, and build stronger relationships with stakeholders so they are prioritised.
Financial Ratios Used	Focus is on metrics like Net Profit Margin, Return on Investment, turnover ratio, and accounts receivable turnover ratio.	Focuses on metrics such as earnings per share, price to earnings (P/E) ratio, and price to book (P/B) ratio.
Value Creation	More emphasis is put on immediate earnings.	Emphasis is on increasing the overall value of the company.

Maximisation Procedure	Increases the earning capacity of the company.	Increases the value of the company's stock for shareholders.

Role of a Financial Manager

Financial activities of a firm is one of the most important and complex activities of a firm. Therefore, in order to take care of these activities a financial manager performs all the requisite financial activities.

A financial manager is a person who takes care of all the important financial functions of an organization. The person in charge should maintain a far sightedness in order to ensure that the funds are utilized in the most efficient manner. His/her actions directly affect the Profitability, growth and goodwill of the firm.

1.Forecasting and planning

The financial manager needs to be aware of the current market trends and should be able to assume the future too. He needs to interact with other executives and lay the business plans carefully, shaping the future of the business firm.

2.Coordination and control

He should exhibit proper coordination with other departments and control the overall business enterprise financially. He needs to consider all the decisions and activities of the organization and integrate them into his financial planning.

3.Raising of funds

A business will need enough cash and liquidity to meet all its obligations. It can raise funds in the form of debt or equity. A financial manager needs to tactfully decide the ratio between equity and debt. Maintaining this ratio is quite necessary.

4.Allocation of funds

After raising funds through various channels, it is necessary to allocate the funds properly. While allocating the funds, the finance should be used in an optimum manner. While the allocation of funds, the following points should be kept in mind:

1. Size of firm and growth capacity
2. Mode of fundraising
3. Long-term or short-term assets

5.Planning for the profit

Making a profit is the primary objective of any business enterprise. Profit earning is necessary for the sustenance and survival of a business organization. Profit planning basically means apt usage of the profit earned.

An organization generates profit because of multiple factors, for instance, industry competition, pricing, state of the economy, cost and output, mechanism of demand and supply, and so on. There should be a healthy mix of fixed and variable factors of production. This helps in enhancing the profitability of the business organization.

6.Understanding the capital markets

In a company, regular and continuous sale and purchase of securities keep taking place. Therefore, it is necessary that a financial manager has a clear understanding and proper knowledge of the entire capital market. Security trading in the stock market involves a massive amount of risk. The financial manager, therefore, needs to understand as well as calculate the amount of risk involved in the trading of debentures and shares.

It is totally up to the financial manager as to how to use as well as distribute the profits. Some investors are there who do not prefer the profits to be distributed among the shareholders in the form of dividends. Rather, they want the profit to enhance the growth and development of the organization. On the other hand, the shareholders will always want profit distribution in the form of dividends. The financial manager needs to tactfully manage all these contradictions.

7.Risk management

Each and every business is vulnerable to risks. Natural disasters like floods, fire, cyclone, or change in the rates of interests, uncertainties in the prices of commodities and shares, fluctuation of foreign exchange rates, etc., all lead to risks for a business. But, it is possible to cope with these risks in the form of insurance purchases or by hedging.

A financial manager has the responsibility to take care of and tackle all the business risks. He should undertake the risk management programs like identification of risks, and then hedge the risks effectively.

8.Cash Flow Management

The role of the financial manager in cash flow management helps in working capital management by ensuring that the company has sufficient cash flow to meet its short-term liabilities and operating expenses. Cash flow management also includes liquidity management by maintaining the ability to quickly convert assets to cash without significant loss.

9.Strategic Planning and Performance Evaluation

Strategic planning aligns financial strategies with the organization’s long-term goals. Financial managers evaluate and support strategic initiatives and business development opportunities, assisting in mergers, acquisitions, and other strategic transactions.

Performance evaluation includes establishing and tracking key financial performance indicators. Financial managers compare performance to industry norms and rivals and use variance analysis to find differences between actual and anticipated performance.

Emerging Challenges Faced by Financial Managers

The role of a financial manager is becoming increasingly complex due to rapid changes in technology, regulations, economic conditions, and sustainability concerns. To navigate these challenges effectively, financial managers must adopt innovative strategies while ensuring compliance and financial stability. The key emerging challenges are explained below:

1. Technological Disruptions and Digital Transformation

The financial sector is undergoing a major digital revolution with the adoption of artificial intelligence (AI), blockchain, and fintech innovations. Financial managers must integrate these technologies to improve efficiency, automate financial processes, and enhance data security. However, the rise of cyber threats poses significant risks, making cybersecurity measures a critical priority. Additionally, real-time financial analytics and automation are reshaping decision-making, requiring financial managers to stay updated on emerging technologies and their applications in financial management.

2. Regulatory and Compliance Challenges

The global financial landscape is becoming more complex due to stringent regulatory frameworks such as International Financial Reporting Standards (IFRS), Basel III, and the General Data Protection Regulation (GDPR). Financial managers must ensure transparency in financial reporting and governance to meet compliance requirements. Additionally, the increasing focus on Environmental, Social, and Governance (ESG) factors is pushing financial managers to incorporate sustainability reporting and ethical finance practices, further complicating financial management processes.

3. Managing Economic Uncertainty and Inflation

Financial managers operate in an environment of constant economic uncertainty driven by geopolitical events, pandemics, and fluctuations in global markets. The impact of inflation erodes purchasing power and increases costs for businesses, making financial planning more challenging. Currency fluctuations further complicate international financial operations, requiring financial managers to develop strategies for hedging risks and ensuring financial stability amidst volatile economic conditions.

4. Sustainable Financial Management

Sustainability is becoming a critical aspect of financial decision-making as businesses and investors demand greater accountability for environmental and social impacts. Financial managers must integrate green finance strategies, such as impact investing and carbon-neutral financing, to align with sustainable development goals. Balancing profitability with long-term environmental and social sustainability requires careful financial planning and investment in ethical business practices, adding another layer of complexity to financial management.

5. Risk Management and Crisis Preparedness

Market volatility, financial fraud, and cybersecurity threats are increasing the need for robust risk management strategies. Financial managers must anticipate potential risks and develop crisis preparedness plans to mitigate financial losses. The rise in cyberattacks on financial institutions necessitates enhanced digital security protocols. Moreover, unpredictable global events, such as pandemics or trade conflicts, highlight the importance of scenario planning and financial resilience strategies to ensure business continuity.

6. Evolving Workforce and Talent Management

The financial industry is witnessing significant workforce transformations due to the increasing use of financial analytics and automation. Financial managers must bridge the skill gap by hiring and training professionals with expertise in data analytics, fintech, and digital finance. Additionally, the adoption of remote and hybrid work models requires managers to develop new leadership strategies to maintain team productivity, communication, and engagement. Retaining top talent in a highly competitive market further adds to the challenges faced by financial managers.

7. Access to Capital and Cost Optimization

Raising capital has become increasingly complex due to fluctuating interest rates, economic instability, and evolving investor expectations. Financial managers must carefully balance debt and equity financing to optimize the cost of capital while ensuring sustainable business growth. At the same time, cost optimization is a key priority, requiring managers to implement efficient cost-cutting measures without compromising operational efficiency. Achieving this balance is crucial to maintaining financial health and competitive advantage.

8.Communicating with Other Departments

One of the common challenges for finance managers is effectively communicating with other departments. As a finance manager, you're not just dealing with numbers—you also need to collaborate with colleagues across the organisation and engage with various stakeholders.

Since finance plays a crucial role in monitoring the funds flowing in and out of the business, clear communication is essential.

However, especially after the COVID-19 pandemic, many companies have teams spread out, with employees working remotely or across different locations. This new work environment can introduce obstacles like:

- Different time zones,
- Unreliable internet connections,
- And an overreliance on teleconferencing tools

UNIT-2

CAPITAL BUDGETING

Capital Budgeting:

Capital budgeting is the process of making investment decision in long-term assets or courses of action. Capital expenditure incurred today is expected to bring its benefits over a period of time. These expenditures are related to the acquisition & improvement of fixes assets.

Capital budgeting is the planning of expenditure and the benefit, which spread over a number of years. It is the process of deciding whether or not to invest in a particular project, as the investment possibilities may not be rewarding. The manager has to choose a project, which gives a rate of return, which is more than the cost of financing the project. For this the manager has to evaluate the worth of the projects in-terms of cost and benefits. The benefits are the expected cash inflows from the project, which are discounted against a standard, generally the cost of capital.

- **Charles T. Horngreen** – "Capital budgeting is the process of identifying, analyzing, and selecting investment projects whose returns are expected to extend beyond one year."

- **James C. Van Horne** – "Capital budgeting is the process of planning expenditures on assets whose returns will be realized over a period longer than one year."

- **Richard A. Brealey & Stewart C. Myers** – "Capital budgeting is the process of determining which investment projects a firm should undertake to maximize its value."

- **ICMA (Institute of Cost and Management Accountants, UK)** – "Capital budgeting is the process of making investment decisions in capital expenditures,

which include the purchase of fixed assets, the addition of new products, and the replacement of existing equipment."

Importance and the Need for Capital Budgeting

A company's financial manager is responsible for choosing the most profitable capital expenditure proposal. Let us look at the some of importance of capital budgeting.

1. Long-lasting effect on profitability

A long-term vision is crucial for the business to grow and succeed. A slightly wrong decision will impact the company negatively in the long run affecting capital budgeting. Further, it also influences the company's costs, profitability and growth. Hence, if the expenditures are done based on the budget plan, definitely the profitability of the business will increase.

2. Big investments

A company should make wise decisions regarding the investment it makes for the company to grow. If there are limited resources, depending on the available resources capital budgeting should be planned. A bad investment or wrong decision will impact the sustainability of the business. Plus, it impacts the purchase of an asset, rebuilding or replacing the existing equipment.

3. Decisions initiated cannot be undone

Capital investment decisions are vast and are not irreversible. It is difficult most of the time to find a suitable market for capital budgeting. The only thing that can be done is to scrap the assets and bear the losses.

4. Expenditure Control

Research and development for the investment project has to be done. Capital budgeting lays more focus on expenditure. A good project has to be regularly monitored and the expenditure has to be under control or it will turn bad for the business if the expenditure exceeds.

5. Data Flow

The inception of a project begins as a concept, and its acceptance or rejection hinges on factors such as levels of authority and prevailing circumstances. Information is shared with the decision-makers without any barriers which will enable them to make better decisions for the growth of the business.

6. Aids investment decisions

Long-term investments may cause risk to the company if they fail. Any decision taken for the long term has to be carefully considered when accepting the proposal. When making an investment decision, management sacrifices its flexibility and available funds. So, capital budgeting decisions have to be carefully examined before making a decision.

7. Maximise the wealth of your company

All the project investments have to be well-planned before it is pursued, and then the shareholders also take an interest in your company. This will contribute to the growth of the organisation. Any organisational expansion is linked to growth, sales, profitability and assets regarding capital budgeting.

Factors Affecting Capital Budgeting

Several factors can affect capital budgeting decisions in a business. These factors can impact the evaluation, selection, and implementation of investment projects. Some of the key factors include:

Size of the Investment: The size of the investment required for a project can significantly impact capital budgeting decisions. Larger investments may require more thorough analysis and justification compared to smaller investments.

Expected Returns: The expected returns from an investment project play a crucial role in decision-making. Projects with higher expected returns are typically preferred, as they can contribute more to the company's profitability.

Risk and Uncertainty: The level of risk and uncertainty associated with an investment project can affect capital budgeting decisions. Projects with higher levels of risk may require additional analysis and risk management strategies.

Cost of Capital: The cost of capital, or the rate of return required by investors, is an important factor in capital budgeting. Projects with returns lower than the cost of capital may not be considered viable.

Regulatory Environment: The regulatory environment in which a company operates can impact capital budgeting decisions. Compliance with regulatory requirements and laws is crucial in evaluating and selecting investment projects.

Market Conditions: Market conditions, including economic conditions, industry trends, and competitive dynamics, can affect the feasibility of investment projects. Projects that are well-suited to current market conditions are more likely to succeed.

Technological Changes: Rapid technological changes can impact capital budgeting decisions, especially in industries where technology plays a significant role. Companies may need to invest in new technologies to remain competitive.

Social and Environmental Factors: Social and environmental considerations are increasingly important in capital budgeting decisions. Projects that are socially responsible and environmentally sustainable are often preferred.

Internal Factors: Internal factors such as the company's financial position, available resources, and organizational capabilities can also influence capital budgeting decisions. Companies need to assess their internal strengths and weaknesses when evaluating investment projects.

Capital Budgeting Process:

The capital budgeting process involves generation of investment proposal, estimation of cash-flows for the proposals, evaluation of cash-flows, selection of projects based on acceptance criterion and finally the continues revaluation of investment after their acceptance.

The steps involved in capital budgeting process are as follows.

1. Project generation
2. Project evaluation
3. Project selection
4. Project execution

1. Project generation: In the project generation, the company has to identify the proposal to be undertaken depending upon its future plans of activity. After identification of the proposals they can be grouped according to the following categories:

a. Replacement of equipment: In this case the existing outdated equipment and machinery may be replaced by purchasing new and modern equipment.

b. Expansion: The Company can go for increasing additional capacity in the existing product line by purchasing additional equipment.

c. Diversification: The Company can diversify its product line by way of producing various products and entering into different markets. For this purpose, It has to acquire the fixed assets to enable producing new products.

d. Research and Development: Where the company can go for installation of research and development suing by incurring heavy expenditure with a view to innovate new methods of production new products etc.,

2. Project evaluation: In involves two steps.

a. Estimation of benefits and costs: These must be measured in terms of cash flows. Benefits to be received are measured in terms of cash flows. Benefits to be received are measured in terms of cash inflows, and costs to be incurred are measured in terms of cash flows. Techniques used:

- Payback period
- Net Present Value (NPV)
- Internal Rate of Return (IRR)
- Profitability Index (PI)
- Accounting Rate of Return (ARR)

b. Selection of an appropriate criterion to judge the desirability of the project.

3. Project selection: There is no standard administrative procedure for approving the investment decisions. The screening and selection procedure would differ from firm to firm. Due to lot of importance of capital budgeting decision, the final approval of the project may generally rest on the top management of the company. However, the proposals are scrutinized at multiple levels. Sometimes top management may delegate authority to approve certain types of investment

proposals. The top management may do so by limiting the amount of cash out lay. Prescribing the selection criteria and holding the lower management levels accountable for the results.

4. Project Execution: In the project execution the top management or the project execution committee is responsible for effective utilization of funds allocated for the projects. It must see that the funds are spent in accordance with the appropriation made in the capital budgeting plan. The funds for the purpose of the project execution must be spent only after obtaining the approval of the finance controller. Further to have an effective cont. It is necessary to prepare monthly budget reports to show clearly the total amount appropriated, amount spent and to amount unspent.

Capital budgeting Techniques:

The capital budgeting appraisal methods are **techniques of evaluation of investment proposal** will help the company to **decide upon the desirability** of an investment proposal depending upon their; relative **income generating capacity** and **rank them** in order of their desirability. These methods provide the company a set of norms on the basis of which either it has to accept or reject the investment proposal. The most widely accepted techniques used in estimating the cost-returns of investment projects can be grouped under two categories.

1. Traditional methods

2. Discounted Cash flow methods

1. Traditional methods

These methods are based on the principles to determine the desirability of an investment project on the basis of its useful life and expected returns. These methods depend upon the accounting information available from the books of accounts of the

company. These will not take into account the concept of 'time value of money', which is a significant factor to determine the desirability of a project in terms of present value

A. Pay-back period method: It is the most popular and widely recognized traditional method of evaluating the investment proposals. It can be defined, as 'the number of years required to recover the original cash out lay invested in a project'.

According to Weston & Brigham, "The pay back period is the number of years it takes the firm to recover its original investment by net returns before depreciation, but after taxes".

According to James. C. Vanhorne, "The payback period is the number of years required to recover initial cash investment.

The payback period is also called payout or payoff period. This period is calculated **by dividing the cost of the project by the annual earnings after tax but before depreciation** under this method the projects are ranked on the basis of the length of the payback period. A project with the shortest payback period will be given the highest rank and taken as the best investment. The shorter the payback period, the less risky the investment is the formula for payback period is

$$\text{Pay-back period} = \frac{\text{Cash outlay (or) original cost of project}}{\text{Annual cash inflow}}$$

Merits:

1. It is one of the earliest methods of evaluating the investment projects.

2. It is simple to understand and to compute.

3. It does not involve any cost for computation of the payback period

4. It is one of the widely used methods in small scale industry sector

5. It can be computed on the basis of accounting information available from the books.

Demerits:

1. This method fails to consider the cash flows received by the company after the payback period.

2. It doesn't consider the interest factor involved in an investment outlay.

3. It is not consistent with the objective of maximizing the market value of the company's share.

4. It fails to consider the pattern of cash inflows i. e., the magnitude and timing of cash inflows.

B. Accounting (or) Average rate of return method (ARR):

It is an accounting method, which uses the accounting information repeated by the financial statements to measure the probability of an investment proposal. It can be determined by dividing the average income after taxes by the average investment i.e., the average book value after depreciation.

According to 'Soloman', accounting rate of return on an investment can be calculated as the ratio of accounting net income to the initial investment, i.e.,

$$ARR = \frac{\text{Average net income after taxes}}{\text{Average Investment}} \times 100$$

$$\text{Average net income after taxes} = \frac{\text{Total Income after Taxes}}{\text{No. Of Years}}$$

$$\text{Average investment} = \frac{\text{Total Investment}}{2}$$

On the basis of this method, the company can select all those projects whose ARR is higher than the minimumrate established by the company. It can reject the projects with an ARR lower than the expected rate of return. This method can also help the management to rank the proposal on the basis of ARR. A highest rank will be given to a project with highest ARR, where as a lowest rank to a project with lowest ARR.

Merits:

1. It is very simple to understand and calculate.

2. It can be readily computed with the help of the available accounting data.

3. It uses the entire stream of earning to calculate the ARR.

Demerits:

1. It is not based on cash flows generated by a project.

2. This method does not consider the objective of wealth maximization

3. IT ignores the length of the projects useful life.

4. It does not consider the fact that the profits can be re-invested

II: Discounted cash flow methods:

The traditional method does not take into consideration the time value of money. They give equal weight age to the present and future flow of incomes. The DCF

methods are based on the concept that a rupee earned today is more worth than a rupee earned tomorrow. These methods take into consideration the profitability and also time value of money.

A. Net present value method (NPV)

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

According to Ezra Solomon, "It is a present value of future returns, discounted at the required rate of return minus the present value of the cost of the investment."

NPV is the difference between the present value of cash inflows of a project and the initial cost of the project.

According the NPV technique, only one project will be selected whose NPV is positive or above zero. If a project(s) NPV is less than 'Zero'. It gives negative NPV hence. It must be rejected. If there are more than one project with positive NPV's the project is selected whose NPV is the highest.

The formula for NPV is

NPV= Present value of cash inflows – investment.

$$NPV = \frac{C1}{(1+K)} + \frac{C2}{} + \frac{C3}{} + \frac{Cn}{} - Co$$

Co- investment

C1, C2, C3… Cn= cash inflows in different years.

K= Cost of the Capital (or) Discounting rate

D= Years

Merits:

1. It recognizes the time value of money.

2. It is based on the entire cash flows generated during the useful life of the asset.

3. It is consistent with the objective of maximization of wealth of the owners.

4. The ranking of projects is independent of the discount rate used for determining the present value.

Demerits:

1. It is different to understand and use.

2. The NPV is calculated by using the cost of capital as a discount rate. But the concept of cost of capital. If self is difficult to understood and determine.

3. It does not give solutions when the comparable projects are involved in different amounts of investment.

4. It does not give correct answer to a question whether alternative projects or limited funds are available with unequal lines.

B. Internal Rate of Return Method (IRR)

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

According to Weston and Brigham "The internal rate is the interest rate that equates the present value of the expected future receipts to the cost of the investment outlay.

When compared the IRR with the required rate of return (RRR), if the IRR is more than RRR then the project is accepted else rejected. In case of more than one project with IRR more than RRR, the one, which gives the highest IRR, is selected.

The IRR is not a predetermine rate, rather it is to be trial and error method. It implies that one has to start with a discounting rate to calculate the present value of cash inflows. If the obtained present value is higher than the initial cost of the project one has to try with a higher rate. Like wise if the present value of expected cash inflows obtained is lower than the present value of cash flow. Lower rate is to be taken up. The process is continued till the net present value becomes Zero. As this discount rate is determined internally, this method is called internal rate of return method.

$$IRR = L + \frac{P1 - Q}{P1 - P2} \times D$$

L- Lower discount rate

P1 - Present value of cash inflows at lower rate.

P2 - Present value of cash inflows at higher rate.

Q- Actual investment

D- Difference in Discount rates.

Merits:

1. It consider the time value of money

2. It takes into account the cash flows over the entire useful life of the asset.

3. It has a psychological appear to the user because when the highest rate of return projects are selected, it satisfies the investors in terms of the rate of return an capital

4. It always suggests accepting to projects with maximum rate of return.

5. It is inconformity with the firm's objective of maximum owner's welfare.

Demerits:

1. It is very difficult to understand and use.

2. It involves a very complicated computational work.

3. It may not give unique answer in all situations.

C. Probability Index Method (PI)

The method is also called benefit cost ration. This method is obtained cloth a slight modification of the NPV method. In case of NPV the present value of cash out flows are profitability index (PI), the present value of cash inflows are divide by the present value of cash out flows, while NPV is a absolute measure, the PI is a relative measure.

If the PI is more than one (>1), the proposal is accepted else rejected. If there are more than one investment proposal with the more than one PI the one with the highest PI will be selected. This method is more useful incase of projects with different cash outlays cash outlays and hence is superior to the NPV method. The formula for PI is

$$\text{Probability index} = \frac{\text{Present Value of Future Cash Inflow}}{\text{Investment}}$$

Merits:

1. It requires less computational work then IRR method

2. It helps to accept / reject investment proposal on the basis of value of the index.

3. It is useful to rank the proposals on the basis of the highest/lowest value of the index.

4. It is useful to tank the proposals on the basis of the highest/lowest value of the index.

5. It takes into consideration the entire stream of cash flows generated during the useful life of the asset.

Demerits:

1. It is somewhat difficult to understand

2. Some people may feel no limitation for index number due to several limitation involved in their

competitions

3. It is very difficult to understand the analytical part of the decision on the basis of probability index.

Capital Rationing

Capital rationing is the process of selecting the most profitable investment projects when a company has limited financial resources. It occurs when a firm imposes restrictions on the amount of capital available for investment, leading to the prioritization of projects based on their expected returns and risk levels.

Capital is one of the most critical resources for any business, and its efficient allocation determines the long-term success of an organization. However, companies often face financial constraints that prevent them from investing in all profitable projects. This limitation leads to a decision-making process known as **capital rationing**, where businesses prioritize and select investment opportunities that provide the highest value.

Capital rationing plays a crucial role in financial planning and strategic decision-making. It ensures that scarce financial resources are allocated efficiently to maximize returns and minimize risks. By carefully selecting investment projects, companies can maintain financial stability, enhance shareholder wealth, and ensure sustainable growth.

Capital rationing is commonly encountered in situations where a company faces limited funds due to external financing constraints, internal budgetary policies, or economic uncertainties. It forces businesses to adopt a systematic approach to project selection, often using financial evaluation techniques such as **Net Present Value (NPV), Internal Rate of Return (IRR), Profitability Index (PI), and Payback Period.**

Meaning of Capital Rationing

Capital rationing refers to the process of allocating limited capital among various investment opportunities to ensure optimal utilization of financial resources. It involves restricting the total amount of capital available for investment and selecting only the most profitable projects that align with a company's financial and strategic objectives.

In simpler terms, capital rationing means that a business cannot finance all available investment opportunities and must choose projects that provide the highest returns

while fitting within the available budget. It is an essential practice in corporate finance that helps firms manage risks, control expenditures, and maintain liquidity.

Definitions of Capital Rationing:

1. **Charles T. Horngreen** – "Capital rationing is a situation where a firm limits its capital expenditure due to budget constraints or financial restrictions, forcing the selection of the best possible projects within the available funds."
2. **James C. Van Horne** – "Capital rationing is the process of selecting investment projects when the funds available for investment are insufficient to finance all profitable opportunities."
3. **Richard A. Brealey & Stewart C. Myers** – "Capital rationing refers to the restriction of a firm's investment budget, either due to internal policies or external financial constraints, leading to the need for project ranking and selection."
4. **ICMA (Institute of Cost and Management Accountants, UK)** – "Capital rationing is the process of allocating limited investment funds among competing projects in a manner that maximizes overall profitability and aligns with organizational goals."

Key Aspects of Capital Rationing:

1. **Limited Availability of Funds:** Businesses do not have unlimited financial resources and must allocate them carefully.
2. **Project Selection and Prioritization:** Companies rank investment projects based on their expected returns and risk factors.
3. **Financial Discipline:** It ensures that businesses do not overextend their finances, preventing unnecessary financial strain.

4. **Focus on Long-Term Value:** The goal is to select projects that contribute to long-term profitability and sustainability.

Example of Capital Rationing:

Suppose a company has **$10 million** available for investment but receives proposals for projects requiring a total of **$15 million**. Since the company cannot fund all projects, it must prioritize based on profitability and strategic alignment. By using capital budgeting techniques, the firm may choose the most promising projects that maximize returns within the $10 million budget.

Importance of Capital Rationing

1. Optimal Resource Allocation

Capital rationing ensures that businesses allocate their limited financial resources efficiently. Since companies often have multiple investment opportunities but insufficient funds to pursue all of them, capital rationing helps prioritize the most promising projects. By selecting investments with the highest returns and strategic importance, businesses can make the best use of their available capital, leading to sustainable growth and profitability.

2. Maximization of Shareholder Wealth

One of the primary goals of any business is to maximize shareholder wealth. Capital rationing contributes to this by ensuring that financial resources are directed toward projects that generate the highest possible returns. When companies invest in the right projects, their overall profitability increases, leading to higher dividends and stock value appreciation for shareholders. This strategic financial management helps maintain investor confidence and long-term business success.

3. Risk Management

Investing in capital projects always involves a certain level of risk, and capital rationing plays a critical role in managing this risk. By carefully evaluating each investment option, businesses can avoid overcommitting to high-risk projects that may not provide the expected returns. Capital rationing encourages companies to assess the feasibility and potential risks of projects before allocating funds, ensuring financial stability and reducing the chances of losses.

4. Financial Discipline and Control

Capital rationing promotes financial discipline by preventing businesses from overspending or engaging in unplanned investments. It ensures that organizations operate within their financial limits, maintaining adequate liquidity for day-to-day operations. By implementing strict budgetary controls and prioritizing essential investments, capital rationing helps businesses stay financially stable and avoid excessive debt.

5. Supports Strategic Planning

For a business to grow and sustain itself in the long run, it must align its investments with its strategic objectives. Capital rationing ensures that only projects contributing to the company's long-term vision and goals are selected. By following a systematic approach to project selection, businesses can invest in initiatives that enhance their market position, technological capabilities, and overall competitiveness.

6. Encourages Efficient Investment Decision-Making

Capital rationing promotes the use of financial evaluation techniques such as Net Present Value (NPV), Internal Rate of Return (IRR), and Profitability Index (PI) to rank and select projects. These methods provide an objective assessment of a

project's financial viability, helping businesses make informed investment decisions. Instead of relying on intuition or short-term gains, capital rationing ensures that companies choose projects based on solid financial analysis and expected future benefits.

7. Helps in Managing External Financial Constraints

Businesses often face external financial constraints such as limited access to funding, high borrowing costs, or strict lending conditions from banks and investors. Capital rationing helps companies navigate these challenges by ensuring that they operate within their available financial resources. By prioritizing self-financing and selecting only the most critical projects, businesses can maintain a strong financial position and reduce dependency on external funding.

8. Enhances Competitive Advantage

Capital rationing enables businesses to invest in projects that strengthen their market position and enhance their competitive advantage. By allocating funds to high-value initiatives, companies can focus on innovation, technological advancement, and expanding their market reach. Effective capital allocation allows businesses to stay ahead of competitors, improve operational efficiency, and achieve long-term growth and profitability.

Objectives of Capital Rationing

1. Efficient Allocation of Limited Resources

The primary objective of capital rationing is to ensure that scarce financial resources are allocated efficiently. Since businesses often face financial constraints, capital rationing helps prioritize projects that provide the highest returns, ensuring optimal utilization of available funds.

2. Maximizing Return on Investment (ROI)

Capital rationing aims to select investment projects that generate the best possible financial returns. By using financial evaluation techniques such as Net Present Value (NPV), Internal Rate of Return (IRR), and Profitability Index (PI), businesses can focus on projects that enhance overall profitability.

3. Risk Reduction and Financial Stability

Another key objective of capital rationing is to minimize financial risk. By carefully evaluating investment opportunities, businesses can avoid excessive exposure to uncertain or high-risk projects. This process ensures financial stability and prevents potential financial losses.

4. Ensuring Long-Term Business Growth

Capital rationing helps businesses invest in projects that align with their long-term strategic goals. By selecting initiatives that contribute to sustainable growth, companies can enhance their market position, expand operations, and improve their competitive advantage.

5. Maintaining Financial Discipline

By imposing budget constraints, capital rationing promotes financial discipline within an organization. It prevents overspending, ensures proper financial planning, and helps businesses stay within their financial limits while making investment decisions.

6. Supporting Strategic Decision-Making

Capital rationing encourages businesses to adopt a strategic approach when selecting investment projects. It ensures that capital is allocated to projects that align with the company's mission, vision, and future objectives, rather than short-term gains.

Types of Capital Rationing

Hard Capital Rationing:

- This happens when a company faces external limitations on raising funds through debt or equity.
- The company cannot access additional capital due to factors outside its control, such as unfavorable market conditions, high interest rates, or strict lending conditions imposed by financial institutions.
- It is rigid and less flexible because it is driven by external market forces or economic conditions.
- Reduced expenses may lead to a shortage of capital for future projects.

Soft Capital Rationing:

- This occurs when a company imposes internal restrictions on capital expenditures, often due to managerial decisions or budget constraints, rather than external factors.
- Also known as internal rationing, soft capital rationing occurs due to a company's internal policies.
- A financially conservative organization, for instance, may set a high required return on capital for future projects, leading to self-imposed capital constraints.
- These internal constraints are more flexible and can be adjusted based on changing priorities or circumstances. The company has control over these limits and can modify them as needed.

Advantages of Capital Rationing

Capital rationing gives several advantages to businesses by guaranteeing effective investment management. Some advantages of capital rationing are provided below:

1. **Helps in Selecting High-Return Projects:** Helps companies invest in the most lucrative opportunities. Applies financial measures such as NPV and PI to rank projects. Companies can achieve maximum returns by choosing projects with higher profitability and reduced risks.
2. **Minimises Financial Risk:** Averts overinvestment in risky or speculative business undertakings. Assists firms in keeping financial health stable. Appropriate capital rationing insulates companies against financial losses and maintains long-term viability.
3. **Enhances Cash Flow Management:** Prevents businesses from overstretching their financial resources. Facilitates liquidity to cater to operational requirements. Efficient allocation of funds prevents cash deficiencies and ensures the smooth running of day-to-day operations.
4. **Supports Strategic Decision-Making:** Motivates companies to concentrate on fundamental growth sectors. Aligns investment with long-term business objectives. This enables businesses to invest their resources appropriately and expand systematically.
5. **Improves Financial Discipline:** Promotes judicious budgeting and cost management. Avoids unnecessary capital outlays. Businesses cultivate strong financial discipline by keeping essential investments on the agenda and avoiding wasteful expenditures.

Disadvantages of Capital Rationing

Although capital rationing assists in financial management, it has some limitations that can affect business expansion and profitability. Restricting investments can limit growth, raise opportunity costs, and reduce stakeholder confidence.

1. **Restricts Business Growth:** Refrains from providing expansion opportunities to financially sound companies. Refuses the firm's opportunities to exploit profitable investment prospects. Enterprises might not be able to increase operations or expand into new markets. Inadequate investment can hinder competitive and innovation growth.
2. **Increases Opportunity Cost:** Firms lose access to projects with high returns due to resource constraints. Players with more financial flexibility could attain a competitive advantage. Foregoing profitable projects might lower the potential for future revenue streams. Late investment can cause a loss of market share over time.
3. **May Lead to Suboptimal Capital Allocation:** Hard capital rationing may compel companies to invest in less profitable projects. Companies might value short-term profitability at the expense of long-term viability. Poor investment decisions can erode financial solidity. Companies can fail to accommodate changes in the market environment.
4. **Can Affect Employee and Stakeholder Confidence:** Limiting capital investment might signal financial fragility. Shareholders will take capital rationing as an indicator of poor financial performance. The workers may become apprehensive of employment and prospects. Stakeholders may start questioning the organisation's potential for expansion and earning profits.

Unit no. 4

Meaning and Concept of Capital Structure:

The term ‘structure’ means the arrangement of the various parts. So capital structure means the arrangement of capital from different sources so that the long-term funds needed for the business are raised.

Thus, capital structure refers to the proportions or combinations of equity share capital, preference share capital, debentures, long-term loans, retained earnings and other long-term sources of funds in the total amount of capital which a firm should raise to run its business.

Importance of Capital Structure:

1. **Increase in value of the firm:**

A sound capital structure of a company helps to increase the market price of shares and securities which, in turn, lead to increase in the value of the firm.

2. **Utilisation of available funds**:

A good capital structure enables a business enterprise to utilise the available funds fully. A properly designed capital structure ensures the determination of the financial requirements of the firm and raise the funds in such proportions from various sources for their best possible utilisation.

3. **Maximisation of return:**

A sound capital structure enables management to increase the profits of a company in the form of higher return to the equity shareholders i.e., increase in earnings per share. This can be done by the mechanism of trading on equity i.e., it refers to increase in the proportion of debt capital in the capital structure which is the cheapest source of capital. If the rate of return on capital employed (i.e., shareholders' fund + long- term borrowings) exceeds the fixed rate of interest paid to debt-holders, the company is said to be trading on equity.

4. **Minimisation of cost of capital:**

A sound capital structure of any business enterprise maximises shareholders' wealth through minimisation of the overall cost of capital. This can also be done by incorporating long-term debt capital in the capital structure as the cost of debt capital is lower than the cost of equity or preference share capital since the interest on debt is tax deductible.

5. **Solvency or liquidity position:**

A sound capital structure never allows a business enterprise to go for too much raising of debt capital because, at the time of poor earning, the

solvency is disturbed for compulsory payment of interest to .the debt- supplier.

6. **Flexibility:**

A sound capital structure provides a room for expansion or reduction of debt capital so that, according to changing conditions, adjustment of capital can be made.

7. **Undisturbed controlling:**

A good capital structure does not allow the equity shareholders control on business to be diluted.

Factors Determining Capital Structure:

The following factors influence the capital structure decisions:

1. **Risk of cash insolvency:**

Risk of cash insolvency arises due to failure to pay fixed interest liabilities. Generally, the higher proportion of debt in capital structure compels the company to pay higher rate of interest on debt irrespective of the fact that the fund is available or not. The non-payment of interest charges and principal amount in time call for liquidation of the company.

2. **Risk in variation of earnings:**

The higher the debt content in the capital structure of a company, the higher will be the risk of variation in the expected earnings available to equity shareholders. If return on investment on total capital employed (i.e., shareholders' fund plus long-term debt) exceeds the interest rate, the shareholders get a higher return.

On the other hand, if interest rate exceeds return on investment, the shareholders may not get any return at all.

3. **Cost of capital:**

Cost of capital means cost of raising the capital from different sources of funds. It is the price paid for using the capital. A business enterprise should generate enough revenue to meet its cost of capital and finance its future growth. The finance manager should consider the cost of each source of fund while designing the capital structure of a company.

4. **Control:**

The consideration of retaining control of the business is an important factor in capital structure decisions. If the existing equity shareholders do not like to dilute the control, they may prefer debt capital to equity capital, as former has no voting rights.

5. **Trading on equity:**

The use of fixed interest bearing securities along with owner's equity as sources of finance is known as trading on equity. It is an arrangement by which the company aims at increasing the return on equity shares by the use of fixed interest-bearing securities (i.e., debenture, preference shares etc.).

6. **Government policies:**

Capital structure is influenced by Government policies, rules and regulations of SEBI and lending policies of financial institutions which change the financial pattern of the company totally. Monetary and fiscal policies of the Government will also affect the capital structure decisions.

7. **Size of the company:**

Availability of funds is greatly influenced by the size of company. A small company finds it difficult to raise debt capital. The terms of debentures and long-term loans are less favourable to such enterprises. Small companies have to depend more on the equity shares and retained earnings.

On the other hand, large companies issue various types of securities despite the fact that they pay less interest because investors consider large companies less risky.

8. **Needs of the investors:**

While deciding capital structure the financial conditions and psychology of different types of investors will have to be kept in mind. For example, a poor or middle class investor may only be able to invest in equity or preference shares which are usually of small denominations, only a financially sound investor can afford to invest in debentures of higher denominations.

A cautious investor who wants his capital to grow will prefer equity shares.

9. **Flexibility**:

The capital structures of a company should be such that it can raise funds as and when required. Flexibility provides room for expansion, both in terms of lower impact on cost and with no significant rise in risk profile.

10. **Period of finance:**

The period for which finance is needed also influences the capital structure. When funds are needed for long-term (say 10 years), it should be raised by issuing debentures or preference shares. Funds should be raised by the issue of equity shares when it is needed permanently.

11. **Nature of business:**

It has great influence in the capital structure of the business, companies having stable and certain earnings prefer debentures or preference shares and companies having no assured income depends on internal resources.

12. **Legal requirements:**

The finance manager should comply with the legal provisions while designing the capital structure of a company.

Optimal Capital Structure

Optimal capital structure is a financial measurement that firms use to determine the best mix of debt and equity financing to use for operations and expansions. This structure seeks to lower the cost of capital so that a firm is less dependent on creditors and more able to finance its core operations through equity.

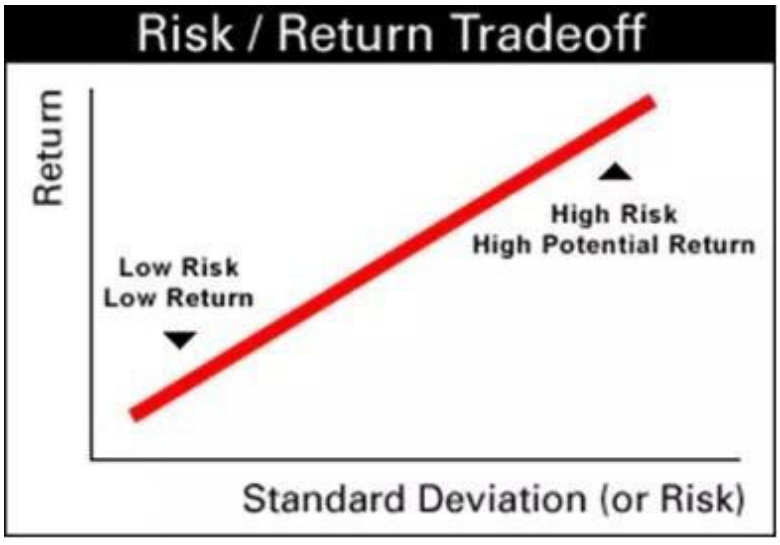
In general, the optimal capital structure is a mix of debt and equity that seeks to lower the cost of capital and maximize the value of the firm. To calculate the optimal capital structure of a firm, analysts calculate the weighted average cost of capital (WACC) to determine the level of

risk that makes the expected return on capital greater than the cost of capital.

Risk-return tradeoff

THE DYNAMICS OF RISK-RETURN TRADEOFF

The graph below is a Risk-Return Trade off the graph. It shows the relationship between these two variables while making an investment.



LOW RISK

The bottom-left corner of the graph shows that there is low return for low-risk financial instruments. Government-issued bonds, for instance, US Treasuries, are considered to be the lowest risk financial instruments because they are backed up by the federal government. But due to the relatively non-speculative nature of the bonds, they have low returns than bonds issued by corporations. In fact, while assessing the expected return of instruments, the return on government bonds is considered to be the risk-free rate.

HIGH RISK

As we move along the upward sloping line in the graph, the risk rises and so does the potential return. This is understandable as investors parting with their money for riskier assets would demand better returns than a risk-free security; else they have no reason to take that risk. This is the reason why the bonds issued by governments and corporations for the same duration have different yields as with corporate bonds, there is also a default risk priced into them which is not the case with federal bonds.

Theories of capital structures

1. NET INCOME APPROACH

Net Income Approach was presented by Durand. The theory suggests increasing value of the firm by decreasing the overall cost of capital which is measured in terms of Weighted Average Cost of Capital. This can be done by having a higher proportion of debt, which is a cheaper source of finance compared to equity finance.

Weighted Average Cost of Capital (WACC) is the weighted average costs of equity and debts where the weights are the amount of capital raised from each source.

According to Net Income Approach, change in the financial leverage of a firm will lead to a corresponding change in the Weighted Average Cost of Capital (WACC) and also the value of the company. The Net Income Approach suggests that with the increase in leverage (proportion of debt), the WACC decreases and the value of firm increases. On the other hand, if there is a decrease in the leverage, the WACC increases and thereby the value of the firm decreases.

ASSUMPTIONS OF NET INCOME APPROACH

Net Income Approach makes certain assumptions which are as follows.

- The increase in debt will not affect the confidence levels of the investors.
- There are only two sources of finance; debt and equity. There are no sources of finance like Preference Share Capital and Retained Earning.
- All companies have uniform dividend pay out ratio; it is 1.
- There is no flotation cost, no transaction cost and corporate dividend tax.
- Capital market is perfect, it means information about all companies are available to all investors and there are no chances of over pricing or under pricing of security. Further it means that all investors are rational. So, all investors want to maximize their return with minimization of risk.
- All sources of finance are for infinity. There are no redeemable sources of finance.

2. Net Operating Income Approach

This approach was put forth by Durand and totally differs from the Net Income Approach. Also famous as traditional approach, Net Operating Income Approach suggests that change in debt of the firm/company or the change in leverage fails to affect the total value of the firm/company. As per this approach, the WACC and the total value of a company are independent of the capital structure decision or financial leverage of a company.

ASSUMPTIONS / FEATURES OF NET OPERATING INCOME APPROACH:

1. The overall capitalization rate remains constant irrespective of the degree of leverage. At a given level of EBIT, the value of the firm would be "EBIT/Overall capitalization rate"
2. Value of equity is the difference between total firm value less value of debt i.e. Value of Equity = Total Value of the Firm – Value of Debt
3. WACC (Weightage Average Cost of Capital) remains constant; and with the increase in debt, the cost of equity increases. An increase in debt in the capital structure results in increased risk for shareholders. As a compensation of investing in the highly leveraged company, the shareholders expect higher return resulting in higher cost of equity capital.

TRADITIONAL APPROACH TO CAPITAL STRUCTURE:

The traditional approach to capital structure advocates that there is a right combination of equity and debt in the capital structure, at which the market value of a firm is maximum. As per this approach, debt should exist in the capital structure only up to a specific point, beyond which,

any increase in leverage would result in the reduction in value of the firm.

ASSUMPTIONS UNDER TRADITIONAL APPROACH:

1. The rate of interest on debt remains constant for a certain period and thereafter with an increase in leverage, it increases.
2. The expected rate by equity shareholders remains constant or increase gradually. After that, the equity shareholders starts perceiving a financial risk and then from the optimal point and the expected rate increases speedily.
3. As a result of the activity of rate of interest and expected rate of return, the WACC first decreases and then increases. The lowest point on the curve is optimal capital structure.

The MM hypothesis of Capital Structure

The Modigliani and Miller approach to capital theory, devised in the 1950s, advocates the capital structure irrelevancy theory. This suggests that the valuation of a firm is irrelevant to the capital structure of a company. Whether a firm is highly leveraged or has a lower debt component has no bearing on its market value. Rather, the market value of a firm is solely dependent on the operating profits of the company. The capital structure of a company is the way a company finances its assets. A company can finance its operations by either equity or different combinations of debt and equity. The capital structure of a company can have a majority of the debt component or a majority of equity, or an even mix of both debt and equity. Each approach has its own set of advantages and disadvantages. There are various capital structure theories that attempt to establish a relationship between the financial leverage of a company (the proportion of debt in the company's capital structure) with its market value. One such approach is the Modigliani and Miller Approach.

The following are the three basic propositions of the MM approach:

(i) The overall cost of capital (KO) and the value of the firm (V) are

independent of the capital structure.

(ii) The cost of equity (KE) is equal to capitalization rate of a pure equity stream plus a premium for the financial risk.

(iii) The cut-off rate for investment purposes is completely independent of the way in which an investment is financed.

ASSUMPTIONS OF MODIGLIANI AND MILLER APPROACH:

- There are no taxes.
- Transaction cost for buying and selling securities, as well as the bankruptcy cost, is nil.
- There is a symmetry of information. This means that an investor will have access to the same information that a corporation would and investors will thus behave rationally.
- The cost of borrowing is the same for investors and companies.
- There is no floatation cost, such as an underwriting commission, payment to merchant bankers, advertisement expenses, etc.
- There is no corporate dividend tax

Arbitrage Process

The "arbitrage process" is the operational justification of MM hypothesis. The term 'Arbitrage' refers to an act of buying an asset or security in one market having lower price and selling it is another market at a higher price. The consequence of such action is that the market price of the securities of the two firms exactly similar in all respects except in their capital structures cannot for long remain different in different markets. Thus, arbitrage process restores equilibrium in value of securities. This is because in case the market value of the two firms which are equal in all overvalued firm would sell their shares, borrow additional funds on personal account and invest in the undervalued firm in order to obtain the same return on smaller investment outlay. The use of debt by the investor for arbitrage is termed as 'home made' or 'personal leverage'.

EBIT-EPS analysis

EBIT-EPS analysis in financial management is a technique used to assess the impact of different financing plans on a company's earnings per share (EPS) at various levels of earnings before interest and taxes (EBIT). It helps determine the optimal capital structure and financing options that maximize shareholder value.

EBIT and EPS:

EBIT represents the company's operating profit before interest and taxes, while EPS is the portion of net income allocated to each outstanding share of common stock.

Why it's important:

EBIT-EPS analysis is crucial for making capital structure decisions, as different financing methods (e.g., debt vs. equity) can have varying impacts on EPS.

ADVANTAGES OF EBIT-EPS ANALYSIS:

Financial Planning:

Use of EBIT-EPS analysis is indispensable for determining sources of funds. In case of financial planning the objective of the firm lies in maximizing EPS. EBIT-EPS analysis evaluates the alternatives and finds the level of EBIT that maximizes EPS.

Comparative Analysis:

EBIT-EPS analysis is useful in evaluating the relative efficiency of departments, product lines and markets. It identifies the EBIT earned by these different departments, product lines and from various markets, which helps financial planners rank them according to profitability and also assess the risk associated with each.

Performance Evaluation:

This analysis is useful in comparative evaluation of performances of various sources of funds. It evaluates whether a fund obtained from a source is used in a project that produces a rate of return higher than its cost.

Determining Optimum Mix:

EBIT-EPS analysis is advantageous in selecting the optimum mix of debt and equity. By emphasizing on the relative value of EPS, this analysis determines the optimum mix of debt and equity in the capital structure. It helps determine the alternative that gives the highest value of EPS as the most profitable financing plan or the most profitable level of EBIT as the case may be.

LIMITATIONS OF EBIT-EPS ANALYSIS

Although EBIT-EPS analysis is a good way to check the earning sensitivity of a company, it has certain limitations too.

1.No Consideration of Risk

The EBIT-EPS analysis does not consider the risk associated with a business project. It simply shows whether the earnings are enough for a corporation. It is not needed in case of a profit larger than returns, but it can be hurting if the opposite situation is there. When the profits are low, but the interest is high, then businesses may be in turmoil.

2.Contradictory Results

When new equity shares are not considered in a different alternative financial plan, the results arising out of this can get erroneous. The comparison of plans also becomes difficult when the number of alternatives increases.

3.Over-capitalization of Funds

This analysis ignores the over-capitalization of the funds. Beyond a certain point, additional capital should not be employed to generate a return in excess of the payments that should be made for its use. The analysis does not address such cases. 5.COST O

Leverage

- Leverage refers to the use of debt (borrowed funds) to amplify returns from an investment or project.
- Investors use leverage to multiply their buying power in the market.
- Companies use leverage to finance their assets: instead of issuing stock to raise capital, companies can use debt to invest in business operations in an attempt to increase shareholder value.

Financial leverage

Financial Leverage is a tool with which a financial manager can maximise the returns to the equity shareholders. The capital of a company consists of equity, preference, debentures, public deposits and other long-term source of funds. He has to carefully select the securities to mobilise the funds. The proper blend of debt to equity should be maintained.

$$\text{Financial Leverage} = \frac{\text{Operating Income / EBIT}}{\text{Taxable Icome / EBT}} \quad \text{or}$$

$$\frac{\text{EBIT}}{\text{EBIT} - \text{I}} = \frac{\text{EBIT}}{\text{EBT}}.$$

EBIT = Earnings before Interest and Tax

EBT = Earnings before Tax, and I = Interest

Operating leverage

There are two major classification of costs in the organisation. They are-
(a) Fixed cost, (b) Variable cost.*High operating leverage*.

The operating leverage has a bearing on fixed costs. There is a tendency of the profits to change, if the firm employs more of fixed costs in its production process, greater will be the operating cost irrespective of the

size of the production. The operating leverage will be at a low degree when fixed costs are less in the production process.

Operating leverage shows the ability of a firm to use fixed operating cost to increase the effect of change in sales on its operating profits. It shows the relationship between the changes in sales and the charges in fixed operating income. Thus, the operating leverage has impact mainly on fixed cost, variable cost and contribution.

It indicates the effect of a change in sales revenue on the operating profit (EBIT). Higher the operating leverage indicates higher the amount of fixed cost and reduces the operating profit and increases the business risks.

Combined Leverage:

This leverage shows the relationship between a change in sales and the corresponding variation in taxable income. If the management feels that a certain percentage change in sales would result in percentage change to taxable income they would like to know the level or degree of change and hence they adopt this leverage. Thus, degree of leverage is adopted to forecast the future study of sales levels and resultant increase/decrease in taxable income. This degree establishes the relationship between contribution and taxable income.

$$\text{Combined Leverage} = \text{Operating Leverage} \times \text{Financial Leverage}$$

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT/Operating Profit}} \times \frac{\text{EBIT}}{\text{EBT}}$$

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{Earning before Tax}}$$

Measurement of Leverages in Financial Management

Determining the leverage in financial management is also important for quantifying how much a company makes use of debt and other financing tools to boost its returns. It is a true gauge of your risk and how you may want to make financial decisions.

Debt-to-Equity Ratio

The debt-to-equity ratio compares a company's total liabilities to its shareholders' equity. The formula is total liabilities divided by shareholders' equity, and it reveals something about the amount of financial leverage a company has relative to its net worth. The higher the debt-to-equity ratio, a financial measure, of the balance sheet, means more leverage and hence more risky whereas if it is low that does mean risk-averse!

Debt Ratio

The debt ratio assesses how much of a company's total assets are financed by loans. Debt Ratio = Total Debt / Total Assets. This ratio can also indicate the company's overall financial risk; it indicates the proportion of total assets that are claims against them, and therefore has been financed by debt rather than equity. Debt ratio is high, financial leverage and risk are higher.

Interest Coverage Ratio

Interest coverage ratio calculates how well a company is able to pay the interest on its long-term debt. EBIT Interest Coverage Ratio is the ratio of earnings before interest and taxes (EBIT) to the interest expenses. This ratio is a measure of the ease with which interest on outstanding debt can be paid, and it signals better ability to pay off its debt obligations pronounced by higher ratio.

Operating Leverage Ratio

Operating Leverage is a metric that assesses how much of fixed costs form part of the operating structure which involves depreciation and other related expenses. It is the percentage change in operating income and it is divided by (P2 - P1) x Operating Income. A high operating leverage ratio implies that the earnings of a company are

more volatile with respect to sales, which means there is greater in-build scope for profit increments as well as losses.

Financial Leverage Ratio

The Financial Leverage Ratio is a measure analyzing the effect pending debt has on Return On Equity of a company. It is defined as total assets divided by the net equity. It is an indication of the extent to which a company relies on debt (equally with other sources such as equity) and it means greater financial leverage, i.e., higher risk.

Meaning and Definition of Cost of Capital

The role of cost of capital is very important in decision making process of financial management. The cost of capital is used for two purposes, simultaneously, firstly, a comparison of alternative sources of funds may be made to select one which has least cost and maximum contribution to wealth maximisation, secondly, to evaluate investment proposals, as it provides a benchmark to yield a minimum return. A few **definitions on cost of capital**

- J. C. Van Horne, "Cost of capital is a cut-off rate for the allocation of capital to investments of projects. It is the rate of return on a project that will leave un-changed the market price of the stock".
- Lawrence J. Gitman, "The cost of capital is the rate of return a firm must earn on its investments for the market value of the firm to remain unchanged. It can also be thought of as the rate of return required by the market suppliers of capital in order to attract needed financing at a reasonable price".

Importance of Cost of Capital in Financial Management

The cost of capital has a central role in financial management because it provides a way to link investment and financing decisions of a firm. An interrelationship exists between capital budgeting and cost of capital. For example, to determine the size of the capital budget, managers need information about both the returns on investment opportunities and the cost of capital. It helps in two ways, first, assist in identify the

discount rate to be used to evaluate proposed capital investments, second, to serve as guideline in developing capital structure and evaluating financial alternatives. The key usages of cost of capital in financial management are discussed below.

1.Cost of Capital in Capital Budgeting:

The cost capital is the fundamental requirement of capital budgeting technique especially based on discounted cash flows. The acceptance and rejection of a proposal depends upon cost of capital associated with it. A proposal with higher rate of return have lesser net present value in comparison of another proposal with lesser cost of capital, therefore, more chances to reject the proposal with higher cost of capital. Since, the cost of capital represents to minimum rate of return to be earned on an investment, thus, a costly source of finance expects higher rate of return from assets to be funded from such source of finance. Net present value, profitability index, discounted payback period method and many more are based on cost of capital to discount the cash flows. Hence, the cost of capital is very useful in capital budgeting decision.

2.Cost of Capital in Determination of Capital Structure:

Every source of fund has own features, few are costly in comparison of others, some are easily available etc. A firm, commonly, uses both equity and debt as a mix in its total financing. The cost of debt is considered at lower rate in comparison to equity. At the same, there is tax advantage on debt security but not on equity capital. Therefore, an optimum mix of debt and equity is helpful in determination of average cost of capital. In designing an optimal capital structure, the management has to keep in mind the objective of maximising the value of the firm which makes cost of capital important in financial planning of the firm.

3.Cost of Capital and Financial Performance of the Firm:

The average cost of capital of a firm represents risk and return of the firm. A firm with high cost of capital exposed to high rate of risk, and impacts firm's profitability. If the actual profitability of a proposal is more than the projected and actual cost of capital,

the performance may be said to be satisfactory, vice-versa.

4.Cost of Capital and Financial Decisions:

Cost of capital has more usages in financial decision making, e.g., in valuation of retained earnings, dividend policy, capitalization or profit also. Cost of capital involves business risk as well as financial risk, therefore, it recognises the time value of money in optimum manner. Moreover, cost of capital also takes explicit and implicit cost into account, thus, opportunity cost is also considered in financial decision making when the decision is taken on the basis of cost of capital.

5.Cost of Capital and External Users:

Cost of capital is useful in decision making for internal as well as external users. A potential investor, banking institution, short-term lender, creditors also interested to know the cost of capital of the firm. A firm with higher cost of capital, generally, operates at higher risk thus lender may have less favour to advance money to such firm. Sometimes, government also provide financial assistance to companies in danger, but of national or social importance, due to high cost of capital by way of announcing special packages.

Classification of Cost of Capital

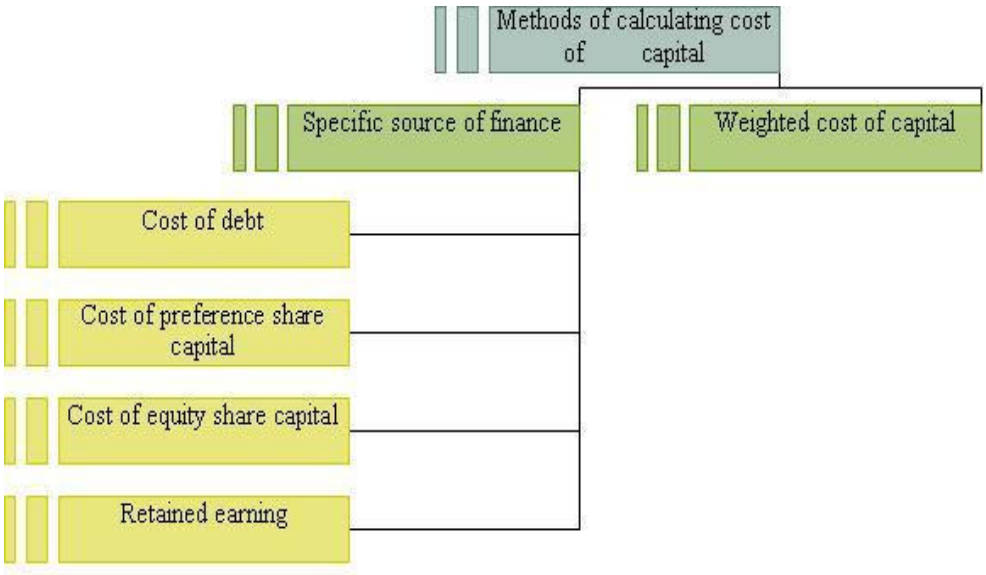
1) Explicit Cost and Implicit Cost : Explicit cost is the discount rate that equate the present value of the expected incremental cash inflows with the present value of its incremental cash out flows. Thus, it is 'the rat 3 return of the cash flows of financing opportunity'. In contrast, implicit cost is the rate of return associated with the best investment opportunity for the firm and its shareholders that will be foregone if the project presently under consideration by the firm were accepted. In a nutshell, explicit costs relate to raising of funds while implicit costs relate to usage of funds

2)Average Cost and Marginal Cost : The average cost is the weighted average of the costs of each components of funds. After ascertaining costs of each source of capital, appropriate weights are assigned to each component of capital. Marginal cost of capital is the weighted average cost of new funds raised by the firm.

3)Future Cost of Capital : Future cost of capital refers to the expected cost to be incurred in raising new funds while historical cost represents cost of capital incurred in the past in procuring funds for the firms. In financial decision making future cost of capital is relatively more relevant.

4)Specific Cost and Combined Cost : The costs of individual components of capital are specific cost of capital. The combined cost of capital is the average cost of capital as it is inclusive of cost of capital from all sources. In capital budgeting decisions, combined cost of capital is used for accepting /rejecting the investment proposals.

Computation of cost of capital



Methods of Calculating Cost of Capital

Cost of capital refers to the required return necessary to make a capital budgeting project worthwhile. It is a critical factor in financial decision-making and is primarily calculated using two approaches:

1. Specific Source of Finance

This method calculates the cost of each individual source of finance separately. Each source of capital has its own cost, and understanding each helps a company estimate

the total cost of funding.

The specific sources include:

a) Cost of Debt

- This is the effective rate that a company pays on its borrowed funds.
- It includes interest payments and is adjusted for tax savings (since interest is tax-deductible).
- **Formula:**

$$Kd = I(1 - T)/NP$$

Where:

III = Interest, *TTT* = Tax rate, *NPNPNP* = Net proceeds from debt

b) Cost of Preference Share Capital

- The cost associated with preference shares, which usually offer a fixed dividend.
- It is calculated based on the dividend and the net proceeds from issuing preference shares.
- **Formula:**

$$Kp = Dp/NP$$

Where:

Dp = Preference dividend, *NP* = Net proceeds from issue

c) Cost of Equity Share Capital

- This is the return expected by equity investors.
- Since equity does not have a fixed dividend, methods like the Dividend Discount Model (DDM) or Capital Asset Pricing Model (CAPM) are often used.
- **Formula (using DDM):**

$$Ke = (D1/P0) + g$$

Where:

$D1$ = Expected dividend, $P0$ = Market price per share, g = Growth rate

d) Retained Earnings

- These are the earnings reinvested in the business rather than paid as dividends.
- The opportunity cost of retained earnings is considered the same as the cost of equity.
- **Formula:**

  Often calculated using the same method as equity capital, i.e.,

  $$Kr=Ke$$

2. Weighted Cost of Capital (WACC)

- After calculating the cost of each source, companies combine them using weights to find the overall cost of capital.
- This is known as the Weighted Average Cost of Capital.
- It reflects the average rate of return a company is expected to pay to all its security holders.
- **Formula:**

$$WACC=(wd\cdot Kd)+(wp\cdot Kp)+(we\cdot Ke)+(wr\cdot Kr)$$

Where:

www = Weight of each source in total capital

KKK = Cost of each source

Importance of Weighted Average Cost of Capital (WACC)

The **Weighted Average Cost of Capital (WACC)** is a crucial concept in corporate finance. It represents the **average rate of return** a company must earn on its investment projects to maintain the value of the firm and satisfy its investors. Here's why WACC is so important:

1. Investment Decision Making

- **WACC acts as a hurdle rate** for evaluating new projects.
- If the **expected return on a project > WACC**, the project is likely to add value

to the firm.

- Helps in **Capital Budgeting** decisions using tools like NPV (Net Present Value) and IRR (Internal Rate of Return).

2. Valuation of Firms

- WACC is used as the **discount rate** when calculating the **present value of future cash flows** in methods like Discounted Cash Flow (DCF) analysis.
- A lower WACC results in a **higher valuation**, and vice versa.

3. Optimal Capital Structure

- Helps determine the right mix of **debt and equity financing**.
- A company can minimize its WACC by finding the most efficient capital structure, which in turn **maximizes shareholder wealth**.

4. Performance Evaluation

- Managers use WACC to assess the **cost of financing** versus the return generated from operations.
- If a company earns more than its WACC, it is said to be **creating value**.

5. Risk Assessment

- WACC reflects the **risk** perceived by investors.
- A higher WACC indicates **higher perceived risk**, making it harder and more expensive to attract investment.

6. Dividend and Retained Earnings Policy

- WACC helps in deciding whether to **distribute earnings** as dividends or **reinvest** in the business.
- Reinvestment is preferred if the company can generate **returns higher than WACC**.

7. Merger and Acquisition (M&A) Decisions

- During M&A, WACC helps in evaluating whether acquiring a company will create or destroy value.
- It helps assess the **cost of financing** for the acquisition.

UNIT-4

WORKING CAPITAL MANAGEMENT

INTRODUCTION

Working capital, also known as short term capital, working capital is a financial metric which represents operating liquidity available to a business. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital. It is calculated as current assets minus current liabilities. If current assets are less than current liabilities, an entity has a working capital deficiency, also called a working capital deficit. Net working capital is working capital minus cash (which is a current asset). It is a derivation of working capital that is commonly used in valuation techniques such as DCFs (Discounted cash flows).

Working Capital = Current Assets − Current Liabilities

DEFINITION OF WORKING CAPITAL

"Working Capital is the excess of C.A. over current liabilities."

CONCEPT OF WORKING CAPITAL MANAGEMENT

There are two concepts of working capital viz .quantitative and qualitative. Some people also define the two concepts as gross concept and net concept.

According to quantitative concept, the amount of working capital refers to 'total of current assets'. Current assets are considered to be gross working capital in this concept.

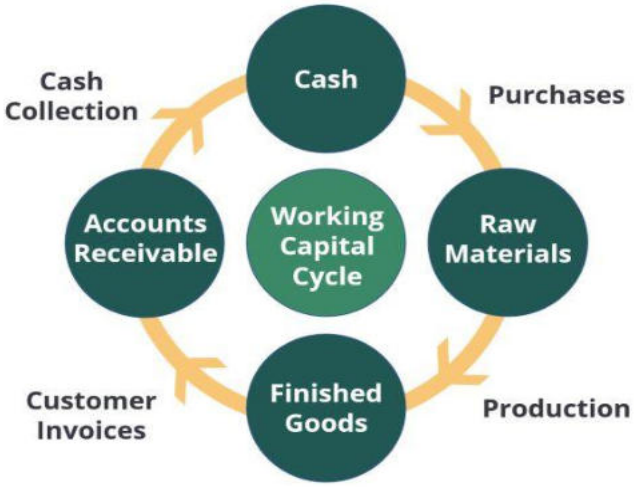
L.J. Guthmann defined working capital as "the portion of a firm's current assets which are financed from long–term funds." The excess of current assets over current liabilities is termed as 'Net working capital'. In this concept "Net working capital" represents the amount of current assets which would remain if all current liabilities were paid.

Both the concepts of working capital have their own points of importance. "If the objectives is to measure the size and extent to which current assets are being used, 'Gross concept' is useful; whereas in evaluating the liquidity position of an undertaking 'Net concept' becomes pertinent and preferable. It is necessary to understand the meaning of current assets and current liabilities for learning the meaning of working capital, which is explained below.

Current assets – It is rightly observed that "Current assets have a short life span. These type of assets are engaged in current operation of a business and normally used for short– term operations of the firm during an accounting period i.e. within twelve months. The two important characteristics of such assets are, (i) short life span, and (ii) swift transformation into other form of assets. Cash balance may be held idle for a week or two; account receivable may have a life span of 30 to 60 days, and inventories may be held for 30 to 100 days.

Current liabilities – The firm creates a Current Liability towards creditors (sellers) from whom it has purchased raw materials on credit. This liability is also known as accounts payable and shown in the balance sheet till the payment has been made to the creditors. The claims or obligations which are normally expected to mature for payment within an accounting cycle (1 year) are known as current liabilities. These can be defined as "those liabilities where liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current assets, or the creation of other current liabilities."

Working Capital Cycle



Objectives of Working Capital Management

Working capital management is all about making sure that a company can meet its short-term financial responsibilities, keeping operations running smoothly, and increasing the value of shares. These are the main goals of managing working capital,

1. Liquidity Management: One is liquidity management, which means making sure the company has enough cash on hand to pay its short-term debts as they come due. To do this, you

need to have enough cash on hand and assets that can be quickly turned into cash to cover your present debts.

2. Optimal Utilisation of Resources: Try to find a balance between keeping enough working cash on hand and not having too many assets that aren't being used. The goal of this purpose is to make the best use of money by avoiding the needless holding costs that come with having too much inventory or accounts receivable.

3. Risk Management: Reduce the risks that come with working capital, like credit risk in accounts payable and inventory going out of date. Strategies for finding, evaluating, and lowering risks that could affect cash are part of good working capital management.

4. Maximizing Profitability: As long as liquidity is maintained, working capital management tries to maximise profitability by keeping the cost of hanging onto extra working capital as low as possible. This includes managing inventory well, negotiating good credit terms, and finding the best ways to collect on accounts outstanding.

5. Effective Cash Flow Management: Make sure you manage cash flows well so that you have a steady flow of cash coming in and going out. This means making accurate predictions about how much cash you will need, collecting receivables quickly, and managing payables wisely.

Factors Affecting the Working Capital

1. Nature of Business

The first factor which helps in determining the requirement of working capital is the type of business in which the company is involved. A trading company or a retail shop requires less working capital as the length of the operating cycle of these types of businesses is small. However, the wholesalers require more working capital, as they have to maintain a large stock and generally sell goods on credit, increasing the length of the operating cycle. Besides, a manufacturing company requires a huge amount of working capital as it has to convert its raw materials into finished goods, sell the goods on credit, and maintain the inventory of raw materials and finished goods.

2. Scale of Operation

The firms that are operating at a large scale need to maintain more debtors, inventory, etc. Hence, these firms generally require a large amount of working capital. However, the firms that are operating at a small scale require less working capital.

3. Business Cycle Fluctuation

A market flourishes during the boom period which results in more demand, more stock, more debtors, more production, etc., ultimately leading to the requirement for more working capital. However, the depression period results in less demand, less stock, fewer debtors, less production, etc., which means that less working capital is required.

4. Seasonal Factors

The companies which sell goods throughout the season require constant working capital. However, the companies selling seasonal goods require a huge amount of working capital during the season, as at that time there is more demand, and the firm has to maintain more stock and supply the goods at a fast speed, and during the off-season, it requires less working capital as the demand is low.

5. Technology and Production Cycle

A company using labour-intensive techniques requires more working capital because it has to maintain enough cash flow for making payments to labour. However, a company using capital-intensive techniques requires less working capital because the investment made by the company in machinery is a fixed capital requirement, and also there will be less operating expenses.

6. Credit Allowed

The average period for collection of the sale proceeds is known as the **Credit Policy.** The credit policy of a company depends on various factors like the client's creditworthiness, industry norms, etc. A company following a liberal credit policy will require more working capital, as it is giving more time to the creditors to pay for the sale made by the company. However, if a company follows a strict or short-term credit policy then it will require less working capital.

7. Credit Avail

The time period that a company is getting credit from its suppliers also affects the requirement for working capital. If a company is getting long-term credit on raw materials from its supplier, then it can manage well with less working capital. However, if a company is getting a short period of credit from its suppliers, then it will require more working capital.

8. Operating Efficiency

If a company has a high degree of operating efficiency then it will require less working capital; however, if a company has a low degree of operating efficiency then it will require more working capital. (Operating cycle of a firm is the time period from the purchase of raw material to the realisation from debtors). Hence, it can be said that the length of the operating cycle directly affects the requirements of the working capital of an organisation.

9. Availability of Raw Materials

If the raw material is easily available to the firm and there is a ready supply of inputs and raw material, then the firm can easily manage with less working capital. Also, as the firm does not need to maintain any stock of raw materials, they can manage with less stock, and hence less working capital. However, if there is a rough supply of raw materials, then the firm will have to maintain a large inventory to carry on the operating cycle smoothly. Therefore, the firm will require more working capital.

10. Level of Competition

If there is competition in the market, then the company will have to follow a liberal credit policy for supplying goods on time. For this, it will have to maintain higher inventories, resulting in more working capital requirements. However, if there is less competition in the market or a company is in a monopoly position, then it will require less working capital, as it can dictate its own terms according to its requirements.

11. Inflation

A rise in the price increases the price of raw materials and the cost of labour, resulting in the increasing requirement for working capital. However, if a company is able to increase the price of its goods also, then it will face less problem with working capital. A rise in price has a different effect on the working capital of different businesses.

12. Growth Prospects

If a firm is planning on expanding its activities then it will require more working capital, as it needs to increase the scale of production for expansion, resulting in the requirement of more inputs, raw materials, etc., ultimately increasing the need for more working capital.

Significance of Working Capital

1. Ensures Smooth Business Operations

Working capital is essential for the uninterrupted day-to-day functioning of a business. It provides the necessary funds to pay for operating expenses such as salaries, rent, raw materials, and utility bills. Without sufficient working capital, a company may struggle to maintain operations, leading to delays, production halts, or customer dissatisfaction.

2. Improves Liquidity

One of the main advantages of working capital is that it enhances a company's liquidity. Liquidity refers to the ability of a firm to meet its short-term obligations. A positive working capital position ensures that the business can pay off its current liabilities as they become due, which protects it from financial stress or insolvency.

3. Aids in Better Cash Management

Effective working capital management helps businesses control and monitor their cash flow. It ensures that there is neither too much idle cash nor a shortage of it. This balance helps in planning for future needs and prevents situations where a company might need to take on short-term loans to meet urgent expenses.

4. Supports Inventory Management

Working capital allows companies to maintain adequate inventory levels. Having enough stock helps meet customer demand without delays, which improves satisfaction and loyalty. At the same time, it helps avoid overstocking, which can lead to higher storage costs or wastage.

5. Builds Creditworthiness

Companies that manage their working capital well are more likely to pay their suppliers and creditors on time. This punctuality builds trust and improves the company's credit score or

financial reputation. As a result, it becomes easier to secure favorable credit terms or loans in the future.

6. Enhances Profitability

When a company has sufficient working capital, it can take advantage of opportunities such as early payment discounts or bulk purchase deals. This reduces operating costs and improves profit margins. Efficient use of working capital also means fewer idle resources and better returns on investments.

7. Encourages Growth and Expansion

Positive working capital enables a business to invest in new projects, accept larger orders, or enter new markets. It provides the flexibility to expand operations without waiting for external funding, which can speed up growth and increase market share.

8. Helps in Financial Planning and Control

Monitoring and managing working capital is crucial for sound financial planning. It helps in forecasting future financial needs, identifying areas of inefficiency, and ensuring that the company has the resources it needs to achieve its goals. Strong control over working capital also helps reduces financial risks.

Sources of Working Capital:

A company has various sources of working capital. Depending upon its condition and requirements, a company may use any of these sources of working capital. These sources may be spontaneous, short-term, or long-term.

- **Spontaneous Sources**: The sources of capital created during normal business activity are called spontaneous sources of working capital. The amount and credit terms vary from industry to industry and depend on the business relationship between the buyer and seller. The main characteristic of spontaneous sources is ‘zero-effort’ and ‘negligible cost’ compared to traditional financing methods. The primary sources of spontaneous working capital are trade credit and outstanding expenses.

- **Short-term Sources**: The sources of capital available to a business for less than one year are called short-term sources of working capital.
- **Long-term Sources**: The sources of capital available to a business for a longer period, usually more than one year, are called long-term sources of working capital.

Short-term sources of working capital

Short-term sources of capital may further be divided into two categories – Internal Sources and External Sources.

The short-term internal sources of working capital include provisions for tax and dividends. These are essentially current liabilities that cannot be delayed beyond a point. All companies make separate provisions for making these payments. These funds are available with the company until these payments are made. Hence, these are called the internal sources of working capital. However, this value is relatively small and thus not that significant.

On the other hand, the short-term external sources of working capital include capital from external agencies like banks, NBFCs, or other financial entities. Some of the primary sources of short-term external sources of working capital are listed below:

- **Loans from Commercial Banks**: Businesses, mostly MSMEs, can get loans from commercial banks with or without offering collateral security. There is no legal formality involved except creating a mortgage on the assets. Repayment can be made in parts or lump sum at the time of loan maturity. At times, banks may offer these loans on the personal guarantee of the directors of a country. They get these loans at concessional rates; hence it is a cheaper source of financing for them. However, the flip side is that getting this loan is a time-consuming process.
- **Public Deposits**: Many companies find it easy and convenient to raise funds for meeting their short-term requirements from public deposits. In this process, the companies invite their employees, shareholders, and the general public to deposit their savings with the company. As per the Companies Act 1956, companies can advertise their requirements and raise money from the general public against issuing shares or debentures. The companies offer higher interest rates than bank deposits to attract the general public. The

biggest of this source of financing is that it is simple and cheaper. However, its drawback is that it may not be available during the depression and financial stringency.

- **Trade Credit**: Companies generally source raw materials and other items from suppliers on credit. The amount payable to these suppliers is also treated as a source of working capital. Usually, the suppliers grant their buyers a credit period of 3 to 6 months. Thus, they provide, in a way, short-term finance to the purchasing company. The availability of trade credit depends on various factors like the buyer's reputation, financial position, business volume, and degree of competition, among others. However, when a business avails trade credit, it stands to lose the benefit of cash discount, which it would earn if they make the payment within 7 to 10 days of making the purchase. This loss of cash discount is treated as an implicit cost of trade credit.
- **Bill Discounting**: Just as business buys goods on credit, they offer credit to their buyers. The credit period may vary from 30 days to 90 days and sometimes extends, even up to 180 days. During this period, the company funds get blocked, which is not good. Instead of waiting that long, sellers prefer to discount these bills with a bank or NBFC. The financial entity charges some amount as commission, called a 'discount', and makes the balance payment to the sellers. This discount compensates them for the time gap between disbursing and collecting the money on the maturity of the bill. This 'discount' charged by the bank is treated as the cost of raising funds through this method. Businesses widely use this method for raising short-term capital.
- **Bank Overdraft:** Some banks offer their esteemed customers and current account holders a facility to withdraw a certain amount of money over and above the funds held by them in their current account with the bank. The bank charges interest on the amount overdrawn and the period it is withdrawn. The overdraft facility is also granted against securities. The bank sets this limit and is subject to revision anytime, depending upon the customer's creditworthiness.
- **Advances from Customers:** One effortless way to raise funds to meet the short-term requirement is to ask customers for some payment in advance. This advance confirms the order and gives much-needed cash to the business. No interest is payable to the customer for this advance. Even if any business pays interest, it is very nominal. Hence, this is one

of the cheapest sources of raising funds to meet companies' short-term working capital requirements. However, this is possible only when the customers do not choose the terms of the sellers.

Long-term sources of working capital

When the companies require funds for more than one year, it makes sense to go for long-term sources, as they are generally cheaper than short-term sources.

Like short-term sources, long-term sources may also be classified as internal and external sources. Retained profits and accumulated depreciation are internal sources wholly earned and owned by the company itself. These funds are available to a company without any direct cost.

The external sources of long-term sources of working capital are listed below:

- **Share Capital**: The Company may raise funds by offering the prospective shareholders a stake in their business. These shares may be held by the general public, banks, financial institutions, or even other companies. The response depends on several factors, including the company's reputation, perceived profit potential, and general economic condition. In return, the company offers dividends to their shareholders, which along with the floating cost, is treated as the cost of sourcing. However, the company is not legally bound to pay this dividend. Also, no rule prescribes how much dividend is to be given. All this makes this a very cheap source of working capital. But, in reality, most companies do not use this for meeting their working capital needs.
- **Long-term Loans**: Also called Working Capital Loans, these long-term loans may be temporary or long-term. The long-term here is generally 84 months (7 years) or more. This loan is not taken for buying long-term assets or investments and is used to provide working capital to meet a company's short-term operational needs. Experts advise using long-term sources for permanent needs and short-term sources for temporary working capital needs.
- **Debentures**: Like shares, debentures also include generating money from the general public, financial institutions, and other companies. However, unlike shares, in the case of debentures, the company has to declare the interest they will pay to their lenders openly.

The company is legally bound to pay the agreed interest. So, here, if the funds are unused or even if the company runs into losses, they have to pay the lenders.

Issues in Dividend Decisions

There are several complexities that come with making dividend decisions.

1. Sustainability

A company must ensure its **dividend policy is sustainable over the long term**. This means that it should not pay high dividends in good years and drastically reduce them in bad years, as this can affect investor confidence. A consistent and stable dividend policy reflects good financial management and helps maintain the company's credibility in the market. Firms should carefully assess their cash flows and future earnings before deciding on dividend payments to avoid overcommitting.

2. Earnings Stability

When a company's **earnings are stable**, it becomes easier to plan and distribute dividends. However, **fluctuating or unpredictable earnings** make it challenging to maintain a steady dividend policy. In such cases, companies might choose to retain a larger portion of profits to ensure financial stability. A steady earnings pattern enables companies to assure shareholders of regular dividend payments, which is often seen positively in the stock market.

3. Growth Opportunities

Companies with **high growth potential** often prefer to **retain profits** rather than distribute them as dividends. This is because reinvesting profits into business expansion, research, or new projects can generate **higher returns in the future**. Investors in such companies may accept lower or no dividends today with the expectation of **capital gains** through higher share prices in the future. Tech startups and R&D-intensive companies often follow this approach.

4. Market Expectations

Investors and market analysts often develop **expectations** about the dividend policies of firms. If a company pays a lower dividend than expected, it might be interpreted as a **negative signal**, leading to a drop in share prices. On the other hand, **meeting or exceeding dividend expectations**

can improve investor confidence and maintain stock value. Therefore, companies often align their dividend decisions with **market sentiment** and shareholder expectations.

5. Dividend vs Retention

This refers to the **trade-off between paying dividends to shareholders and retaining earnings** for internal use.

- **High dividend payout** → Less money retained → Less reinvestment capacity
- **High retention** → Fewer dividends → Might dissatisfy shareholders seeking regular income

  A **balanced dividend policy** aims to provide adequate returns to shareholders while also retaining enough funds for growth and future needs.

6. Present vs Future

There is often a **conflict between short-term and long-term interests**:

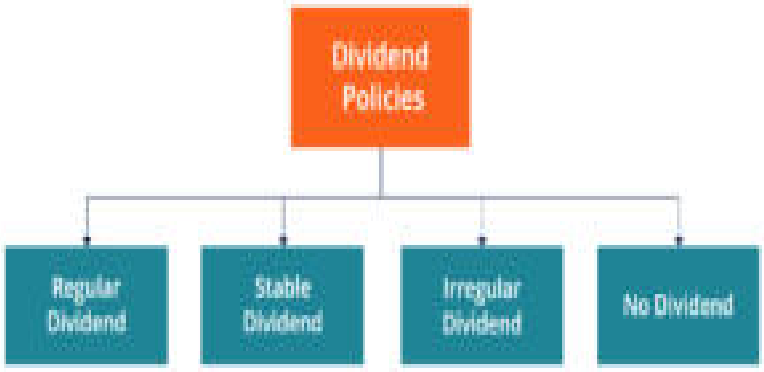
- **Current shareholders** may prefer **higher dividends now** as an immediate return on their investment.
- The **firm's management** may prioritize **future sustainability and growth**, which requires retaining more earnings.

  A wise dividend policy considers both perspectives to **maximize long-term shareholder value** while also maintaining satisfaction in the short term.

TYPES OF DIVIDEND POLICY

What is a Dividend Policy?

A company's dividend policy dictates the amount of dividends paid out by the company to its shareholders and the frequency with which the dividends are paid out. When a company makes a profit, they need to make a decision on what to do with it. They can either retain the profits in the company (retained earnings on the balance sheet), or they can distribute the money to shareholders in the form of dividends.



What is a Dividend?

A dividend is the share of profits that is distributed to shareholders in the company and the return that shareholders receive for their investment in the company. The company's management must use the profits to satisfy its various stakeholders, but equity shareholders are given first preference as they face the highest amount of risk in the company. A few examples of dividends include:

1. Cash dividend

A dividend that is paid out in cash and will reduce the cash reserves of a company.

2. Bonus shares

Bonus shares refer to shares in the company that are distributed to shareholders at no cost. It is usually done in addition to a cash dividend, not in place of it.

Examples of Dividend Policies

The dividend policy used by a company can affect the value of the enterprise. The policy chosen must align with the company's goals and maximize its value for its shareholders. While the shareholders are the owners of the company, it is the board of directors who make the call on whether profits will be distributed or retained.

The directors need to take a lot of factors into consideration when making this decision, such as the growth prospects of the company and future projects. There are various dividend policies a company can follow such as:

1. Regular dividend policy

Under the regular dividend policy, the company pays out dividends to its shareholders every year. If the company makes abnormal profits (very high profits), the excess profits will not be distributed to the shareholders but are withheld by the company as retained earnings. If the company makes a loss, the shareholders will still be paid a dividend under the policy.

The regular dividend policy is used by companies with a steady cash flow and stable earnings. Companies that pay out dividends this way are considered low-risk investments because while the dividend payments are regular, they may not be very high.

2. Stable dividend policy

Under the stable dividend policy, the percentage of profits paid out as dividends is fixed. For example, if a company sets the payout rate at 6%, it is the percentage of profits that will be paid out regardless of the amount of profits earned for the financial year.

Whether a company makes $1 million or $100,000, a fixed dividend will be paid out. Investing in a company that follows such a policy is risky for investors as the amount of dividends fluctuates with the level of profits. Shareholders face a lot of uncertainty as they are not sure of the exact dividend they will receive.

3. Irregular dividend policy

Under the irregular dividend policy, the company is under no obligation to pay its shareholders, and the board of directors can decide what to do with the profits. If they make an abnormal profit in a certain year, they can decide to distribute it to the shareholders or not pay out any dividends at all and instead keep the profits for business expansion and future projects.

The irregular dividend policy is used by companies that do not enjoy a steady cash flow or lack liquidity. Investors who invest in a company that follows the policy face very high risks as there is a possibility of not receiving any dividends during the financial year.

4. No dividend policy

Under the no-dividend policy, the company doesn't distribute dividends to shareholders. It is because any profits earned are retained and reinvested into the business for future growth. Companies that don't give out dividends are constantly growing and expanding, and shareholders

invest in them because the value of the company stock appreciates. For the investor, the share price appreciation is more valuable than a dividend payout.

💼 CORPORATE DIVIDEND BEHAVIOR

Q: What is Corporate Dividend Behavior?

A: Corporate dividend behavior refers to the patterns and decisions made by companies regarding the distribution of dividends to their shareholders. It encompasses the strategies, trends, and factors that influence how companies manage their dividend policies over time.

Q: What Factors Influence Corporate Dividend Behavior?

- 💰 **Earnings Stability:** Companies with stable earnings are more likely to maintain consistent dividend payments to shareholders.
- 📈 **Financial Health:** The financial health and cash flow position of the company influence its ability to pay dividends.
- 👥 **Investor Preferences:** Understanding shareholder preferences and expectations regarding dividend income plays a significant role in shaping corporate dividend behavior.
- 🌐 **Market Conditions:** Economic conditions, industry trends, and regulatory factors impact corporate dividend decisions.

Q: What Are the Different Types of Corporate Dividend Behavior?

- 🔄 **Regular Dividend Payers:** Companies that consistently pay dividends at regular intervals, reflecting stable earnings and a commitment to shareholder returns.
- ❓ **Irregular Dividend Payers:** Companies that pay dividends sporadically, often based on specific circumstances or earnings performance.
- 📊 **Dividend Initiators:** Companies that introduce dividend payments for the first time, signaling financial maturity and confidence in future earnings.
- 📉 **Dividend Cutters:** Companies that reduce or suspend dividend payments due to financial challenges or strategic shifts.

Q: How Does Corporate Dividend Behavior Impact Shareholder Perception?

A: Corporate dividend behavior can influence shareholder perception in several ways:

- 📈 **Positive Perception:** Consistent and increasing dividends are often viewed positively by investors, signaling financial stability and confidence in future earnings.
- 📉 **Negative Perception:** Reductions or omissions of dividends may raise concerns among shareholders about the company's financial health and future prospects.
- 🔄 **Stability Perception:** Companies with a history of stable dividend payments may be perceived as less risky investments, attracting income-seeking investors.

Q: How Do Companies Determine their Dividend Behavior?

- 💼 **Financial Analysis:** Conducting thorough financial analysis to assess earnings, cash flow, and liquidity position to determine the feasibility of dividend payments.
- 📊 **Market Benchmarking:** Comparing dividend policies with industry peers and market benchmarks to ensure competitiveness and alignment with shareholder expectations.
- 📈 **Long-Term Strategy:** Incorporating dividend policy into the company's long-term strategic planning to balance shareholder returns with investment opportunities and growth objectives.

Q: What Are the Reporting Requirements for Corporate Dividend Behavior?

A: Companies are required to disclose their dividend policy, dividend payments, and relevant financial information in their annual reports, financial statements, and communications with shareholders. This ensures transparency and accountability in corporate dividend behavior.

STABILITY OF DIVIDENDS

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

Stability of dividends also means regularity in paying some dividend annually, even though the amount of dividend may fluctuate over the years, and may not be related with earnings. There are a number of companies, which have records of paying dividend for a long, unbroken period. More precisely, stability of dividends refers to the amounts paid out regularly. Three forms of such stability may be distinguished:

- Constant dividend per share or dividend rate
- Constant payout
- Constant dividend per share plus extra dividend

Constant Dividend per Share or Dividend Rate

In India, companies announce dividend as a per cent of the paid-up capital per share. This can be converted into dividend per share. A number of companies in India follow the policy of paying a fixed rate on paid-up capital as dividend every year, irrespective of the fluctuations in the earnings. This policy does not imply that the dividend per share or dividend rate will never be increased. When the company reaches new levels of earnings and expects to maintain them, the annual dividend per share (or dividend rate) may be increased. The relationship between earnings per share and the dividend per share under this policy is shown in Figure 18.1.

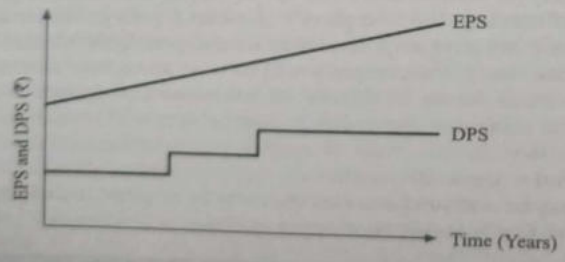


Figure 18.1: *Constant dividend per share policy*

It is easy to follow this policy when earnings are stable. However, if the earnings pattern of a company shows wide fluctuations, it is difficult to maintain such a policy. With earnings fluctuating from year to year, it is essential for a company, which wants to follow this policy, to build up surpluses in years of higher than average earnings to maintain dividends in years of below average earnings. In practice, when a company retains earnings in good years for this purpose, it earmarks this surplus as **dividend equalization reserve**. These funds are invested in current assets like tradable (marketable) securities, so that they may easily be converted into cash at the time of paying dividends in bad years.

A constant dividend per share policy puts ordinary shareholders at per with preference shareholders irrespective of the firm's investment opportunities or the preferences of shareholders.[8] Those investors who have dividends as the only source of their income may prefer the constant dividend policy. They do not accord much importance to the changes in share prices. In the long run, this may help to stabilize the market price of the share.[9]

Constant Payout

The ratio of dividend to earnings is known as **payout ratio**. Some companies may follow a policy of constant payout ratio, i.e., paying a fixed percentage of net earnings every year. With this policy the amount of dividend will fluctuate in direct proportion to earnings. If a company adopts a 40 per cent payout ratio, then 40 per cent of every rupee of net earnings will be paid out. For example, if the company earns ₹2 per share, the dividend per share will be Re 0.80 and if it earns ₹1.50 per share the dividend per share will be Re 0.60. The relation between the earnings per share and the dividend per share under this policy is exhibited in Figure 18.2.

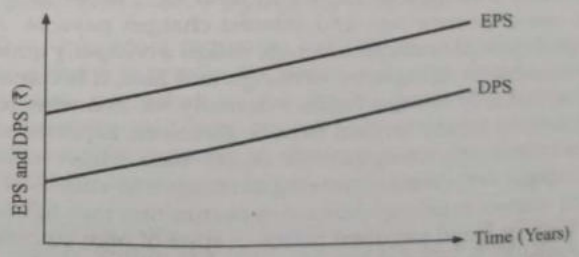


Figure 18.2: *Dividend policy of constant payout ratio*

This policy is related to a company's ability to pay dividends. If the company incurs losses, no dividends shall be paid regardless of the desires of shareholders. Internal financing with retained earnings is automatic when this policy is followed. At any given payout ratio, the amount of dividends and the additions to retained earnings increase with increasing earnings and decrease with decreasing earnings. This policy does not put any pressure on a company's liquidity since dividends are distributed only when the company has profits.[10]

8. Brandt, *op. cit.*, 1972, p. 447.
9. *Ibid.*

Constant Dividend per Share plus Extra Dividend

For companies with fluctuating earnings, the policy to pay a minimum dividend per share with a step-up feature is desirable. The small amount of dividend per share is fixed to reduce the possibility of ever missing a dividend payment. By paying extra dividend (a number of companies in India pay an **interim dividend** followed by a regular, **final dividend**) in periods of prosperity, an attempt is made to prevent investors from expecting that the dividend represents an increase in the established dividend amount. This type of policy enables a company to pay constant amount of dividend regularly without a default and allows a great deal of flexibility for supplementing the income of shareholders only when the company's earnings are higher than the usual, without committing itself to make larger payments as a part of the future fixed dividend. Certain shareholders like this policy because of the certain cash flow in the form of regular dividend and the option of earning extra dividend occasionally.

We have discussed three forms of stability of dividends. Generally, when we refer to a stable dividend policy, we refer to the first form of paying constant dividend per share. A firm pursuing a policy of stable dividend, as shown in Figure 18.1, may command a higher price for its shares than a firm which varies dividend amount with cyclical fluctuations in the earnings as depicted in Figure 18.2.

Merits of Stability of Dividends

The stability of dividends has several advantages as discussed below:

- Resolution of investors' uncertainty
- Investors' desire for current income
- Institutional investors' requirements
- Raising additional finances

Resolution of investors' uncertainty We have argued in the previous chapter that dividends have informational value, and resolve uncertainty in the minds of investors. When a company follows a policy of stable dividends, it will not change the amount of dividends if there are temporary changes in its earnings. Thus, when the earnings of a company fall and it continues to pay the same amount of dividend as in the past, it conveys to investors that the future of the company is brighter than suggested by the drop in earnings. Similarly, the amount of dividends is increased with increased earnings level only when it is possible to maintain it in future. On the other hand, if a company follows a policy of changing dividends with cyclical changes in the earnings, shareholders would not be certain about the amount of dividends.

Investors' desire for current income There are many investors, such as old and retired persons, women, etc., who desire to receive regular periodic income. They invest their savings in the shares with a view to use dividends as a source of income to meet their living expenses. Dividends are like wages and salaries for them. These investors will prefer a company with stable dividends to the one with fluctuating dividends.

Institutional investors' requirements Financial, educational, and social institutions, and unit trusts also invest funds in shares of companies. In India, financial institutions such as LIC and UTI are some of the largest investors in corporate securities. Every company is interested to have these financial institutions in the list of their investors. These institutions may generally invest in the shares of those companies, which have a record of paying regular dividends. These institutional investors may not prefer a company which has a history of adopting an erratic dividend policy. Thus, to cater the requirement of institutional investors, a company prefers to follow a stable dividend policy.

Raising additional finances A stable dividend policy is also advantageous to the company in its efforts to raise external finances. Stable and regular dividend policy tends to make the share of a company as quality investment rather than a speculation. Investors purchasing these shares intend to hold them for long periods of time. The loyalty and goodwill of shareholders towards a company increases with stable dividend policy. They would be more receptive to an offer by the company for further issues of shares. A history of stable dividends serves to spread ownership of outstanding shares more widely among small investors, and thereby reduces the chance of loss of control. The persons with small means, in the hope of supplementing their income, usually purchase shares of the companies with a history of paying regular dividends. A stable dividend policy also helps the sale of debentures and preference shares. The fact that the company has been paying dividend regularly in the past is a sufficient assurance to the purchasers of these securities that no default will be made by the company in paying their interest or preference dividend and returning the principal sum. The financial institutions are the largest purchasers of these securities. They purchase debentures and preference shares of those companies which have a history of paying stable dividends.

Danger of Stability of Dividends

The greatest danger in adopting a stable dividend policy is that once it is established, it cannot be changed without seriously affecting investors' attitude and the financial standing of the company. If a company, with a pattern of stable dividends, misses dividend payment in a year, this break will have an effect on investors more severe