

**BBA 4th**  
**Financial Management**  
**Unit 3<sup>rd</sup>**

**(Topic 1) Capital Structure and Factors affecting Capital Structure**

**Capital Structure** means a combination of all long-term sources of finance. It includes Equity Share Capital, Reserves and Surplus, Preference Share capital, Loan, Debentures and other such long-term sources of finance. A company has to decide the proportion in which it should have its own finance and outsider's finance particularly debt finance.

**Factors affecting Capital Structure**

- **Control-** Determination of capital structure also operates in the company's willingness to maintain control. The issue of equity shares involves the risk of losing control. In this way, if the company is interested – in order to maintain control. He should prefer to use debt and preference share capital for equity share capital.
- **Size of Company-** Small companies may have to rely on the founder's money but as they grow they will be eligible for long-term financing because larger companies are considered less risky by investors.
- **Nature of Business** -If your business is a monopoly you can go for debentures because your sales can give you adequate profits to pay your debts easily or pay dividends.
- **The Regularity of Earnings-** A firm with large and stable incomes may incur more debt in its capital structure, unlike the one that is unstable.
- **Capital Structure of Other Companies:** Capital structure is influenced by the industry to which a company is related. All companies related to a given industry produce almost similar products, their costs of production are similar, they depend on identical technology, they have similar profitability, and hence the pattern of their capital structure is almost similar.
- **Conditions of the Money Markets**—Capital markets are always changing. You don't want to issue company shares during a bear market, you do it when there is a bull run.
- **Government policy**— This is important to consider. A change in lending policy may increase your cost of borrowing.
- **Cost of Floating**— The cost of floating equity is much higher than that of floating debt. This may influence the finance manager to take debt financing the cheaper option.
- **Debt -Equity Ratio**— As stated debt is a liability whose interest has to be paid irrespective of earnings. Equity, on the other hand, is shareholders money and payment

depend on profits being paid. High debt in the capital structure is risky and may be a problem in adverse times. However, debt is cheaper than issuing shares. Debt interest has some tax deductions that is not the case for dividends paid to equity holders.

## **(Topic 2) Optimal Capital Structure**

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.

### Features of A Good Capital Structure

- **Profitability**-it should ensure most profits are earned. It should offer the least cost of financing with maximum returns
- **Solvency**-the structure should not lead the company to a point it risks being insolvent. Too much debt threatens a company's solvency so any debt taken should be manageable
- **Flexibility**-should things change the capital structure should be one that can be easily maneuvered to meet new market demands
- **Control**- the structure should not give away control of the company. So, caution should be taken not to give too much away that owners lose their controlling stake.

## **(Topic 3) Capital Structure Theories**

1. Net Income approach
2. Net Operating Income (NOI) approach
3. Modigliani -Miller Approach
4. Traditional Theory approach

## **1. Net Income approach**

According to this approach, the market value of equity shares is based on the earning available for equity shareholders after the payment of interest on debt if it is included in the Capital Structure. The earning of the firm after the payment of all other expenses except interest on debt is called Net Operating Income (NOI) and the earning available for equity shareholders after the payment of interest is called as "Net Income (NI). Therefore, Net Income = Net Operating Income (NOI) - Interest on debt (I).

According to this approach, as the debt increases, overall or weighted average cost of capital decreases and vice versa. Therefore increase in debt results in the increase in the value of the firm and consequently increases the value of the equity shares of the company.

### **Net Income approach is based on the following assumptions:**

- (i) There are no corporate taxes.
- (ii) The cost of debt is less than the cost of equity i.e. the capitalization rate of debt is less than the rate of equity capitalization. This prompts the firm to borrow.
- (iii) The debt capitalization rate and the equity capitalization rate remain constant.
- (iv) The proportion of the debt does not affect the risk perception of the investors. Investors are only concerned with their desired return.
- (v) The cost of debt remains constant at any level of debt.
- (vi) Dividend pay out ratio is 100%. As per this approach, the firms try to optimize the capital structure by introducing more and more debt having less cost than equity in the capital structure.

Therefore, when the financial leverage is increased the proportion of cheaper source of funds i.e. debt increases and overall cost of capital declines which consequently increases the market value of the firm and also the value of the equity share of the firm. Hence, the optimum capital structure exists when the firm employs 100% debt or maximum debt in the capital structure.

According to this approach, the value of the firm and the value of equity are determined as under.

**Market Value of the firm (V) = Market value of equity (E) + Market value of debt (D)**

$$\text{Market value of Equity (E)} = \frac{NI}{K_e}$$

$$\text{Market Value of Debt (D)} = \frac{I}{K_d}$$

Where,

**NI** = Net income available for equity share holders i.e. NOI-I

**NOI** = Net Operating Income

**I** = Interest on debt

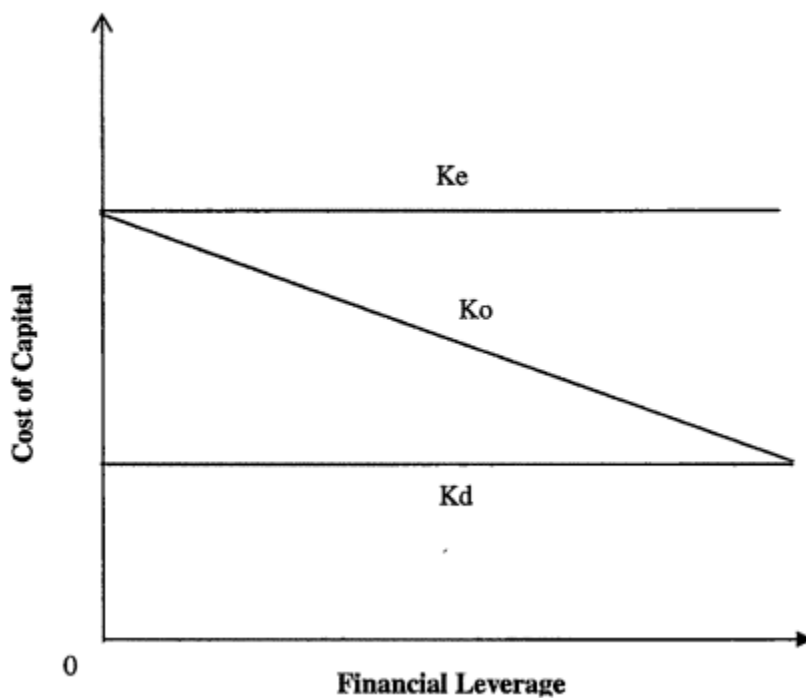
**K<sub>e</sub>** = Rate of equity capitalization (Cost of Equity)

**K<sub>d</sub>** = Rate of debt capitalization (Cost of Debt)

Cost of Capital (K<sub>o</sub>) or Weighted Average Cost of Capital (WACC)

$$K_o/WACC = \frac{\text{Net Operating Income (NOI)}}{\text{Market Value of the firm (V)}}$$

$$\text{Degree of Financial Leverage} = \frac{\text{Market Value of Debt (D)}}{\text{Market Value of firm (V)}}$$



From the above diagram it is clear that as the debt is replaced by equity in the capital structure the weighted average cost of capital ( $K_o$ ) decreases. The WACC decreases because the debt is cheaper than the equity and therefore as the debt increases and equity reduces, the funds having less cost is replaced by the funds having more cost.

**Optimum Capital Structure** under NI Approach The capital structure is said to be optimum at that stage of debt-equity mix where the overall cost of capital is minimum. As per this approach the cost of capital is minimum at 100% level of debt, therefore the capital structure is optimized at the 100% debt level.

### **Criticisms of NI Approach**

- (i) The assumption of constant cost of debt at any level of debt is not correct. The funds providers insist for more rate of interest above certain level of debt.
- (ii) The assumption of risk perception of equity share holders is also not correct. As the debt increases the financial risk also increases and equity share holders will expect more return on their investment and hence the rate equity capitalization also increases with the increase in financial leverage.
- (iii) 100% dividend payout and absence of corporate tax are not practically possible.

### **Example NI approach**

EBIT (i.e., Net Operating income) is Rs. 30,000;  
The equity capitalisation ratio (i.e., cost of equity) is 15% ( $K_e$ );  
Cost of debt is 10% ( $K_d$ );  
Total Capital amounted to Rs. 2,00,000.  
Calculate the cost of capital and the value of the firm for each of the following alternative leverage after applying the NI approach.  
Leverage (Debt to total Capital) 0%, 20%, 50%, 70% and 100%.

**Solution :**

**Statement Showing the Cost of Capital and the Value of the Firm**

Degree of Leverage	0	0.2	0.5	0.7	1.0
	Rs.	Rs.	Rs.	Rs.	Rs.
Equity Capital	2,00,000	1,60,000	1,00,000	60,000	—
Debt Capital	—	40,000	1,00,000	1,40,000	2,00,000
Total	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>
EBIT @ 15%	30,000	30,000	30,000	30,000	30,000
Less : Interest on Debt	—	4,000	10,000	14,000	20,000
Earnings to Equity	<u>30,000</u>	<u>26,000</u>	<u>20,000</u>	<u>16,000</u>	<u>10,000</u>
Market Value of Debt	—	40,000	1,00,000	1,40,000	2,00,000
Market Value of Equity					
Earnings $\left(\frac{\text{Earnings}}{K_e}\right)$	2,00,000	1,73,333	1,33,333	1,06,667	66,667
Total Value of the firm	<u>2,00,000</u>	<u>2,13,333</u>	<u>2,33,333</u>	<u>2,46,667</u>	<u>2,66,667</u>
Thus,					
Cost of Debt ( $K_d$ ) — Given	10%	10%	10%	10%	10%
Cost of Equity ( $K_e$ ) — Given	15%	15%	15%	15%	15%
Average Cost of Capital $\left(\frac{T}{V}\right)$	30%	28%	25%	23%	20%

**Workings :**

Average Cost of Capital is computed as under (under various financing plans) :

$$K_w = \left(\frac{T}{V}\right)K_d + \left(\frac{S}{V}\right)K_e, \text{ substituting the values :}$$

(i) When leverage is 0

$$K_w = 0 \times 10 + 2 \times 15 = 30\%$$

(ii) When leverage is 0.2

$$K_w = .4 \times 10 + .16 \times 15 = 28\%$$

(iii) When leverage is 0.5

$$K_w = .10 \times 10 + .10 \times 15 = 25\%$$

(iv) When leverage is 0.7

$$K_w = .14 \times 10 + .6 \times 15 = 23\%$$

(v) When leverage is 1

$$K_w = .20 \times 10 + 0 \times 15 = 20\%$$

From the above table it is quite clear that the value of the firm (V) will be increased if there is a proportionate increase in debt capital but there will be a reduction in overall cost of capital. So, Cost of Capital is increased and the value of the firm is maximum if a firm uses 100% debt capital.

## 2. Net Operating Income approach

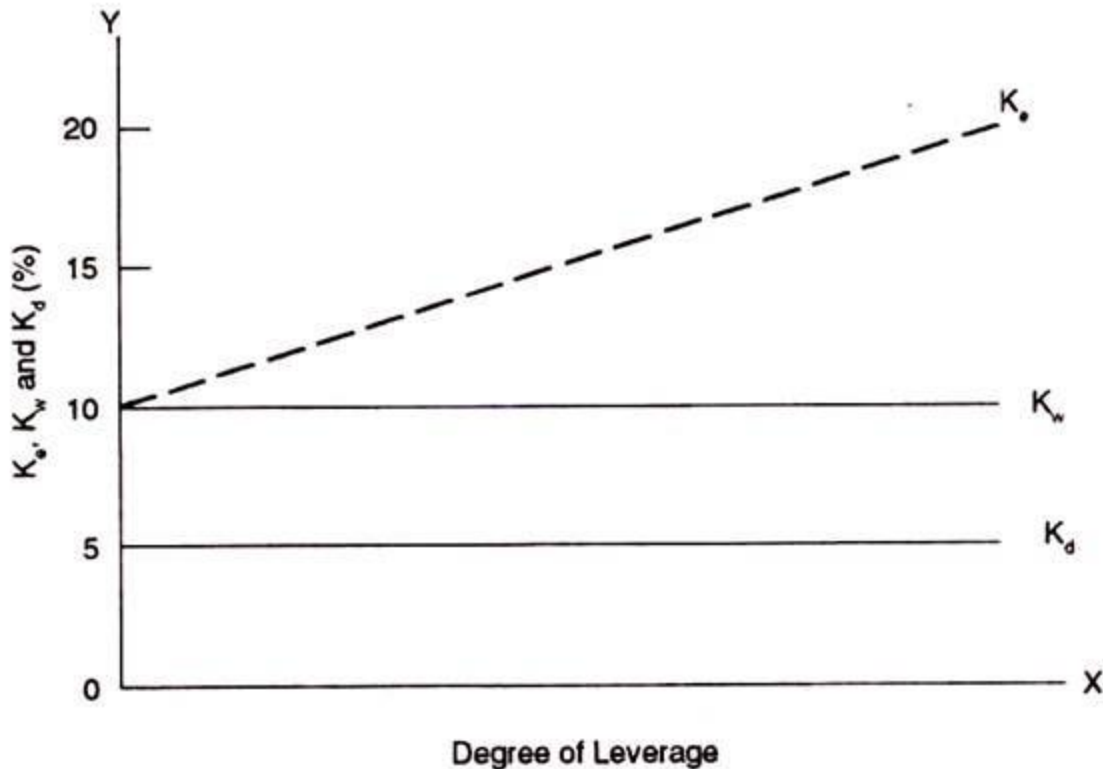
As per this approach, the market value of the firm is based on the earning available for fund providers after paying all other expenses except interest on debt. The profit available for funds providers or for calculating the market value of the firm is called Net operating Income (NOI).

This theory is just opposite to NI approach. NI approach is relevant to capital structure decision. It means decision of debt equity mix does affect the WACC and value of the firm. As per NOI approach the capital structure decision is irrelevant and the degree of financial leverage does not affect the WACC and market value of the firm. NOI approach evaluates the cost of capital and therefore the optimal Capital Structure on the basis of operating leverage by means of NOI approach.

### **The NOI approach is based on following assumptions:**

- (i) There are no corporate taxes.
- (ii) Cost of debt remains constant at all level of debt.
- (iii) Overall cost of capital remains constant.
- (iv) Value of the firm depends on expected net operating income and overall capitalization rate or the opportunity cost of capital.
- (v) Net operating income of the firm is not affected by the degree of financial leverage.
- (vi) The operating risk or business risk does not change with the change in debt equity mix.
- (vii) WACC does not change with the change in financial leverage.

As per NOI approach, even if the firm uses more and more debt in the capital structure, the overall cost does not change even though the debt is cheaper than equity. This is because the equity share holders increase their expectations of return on their investment with every increase in debt resulting in increased business risk. Consequently, the benefit of cheaper debt is offset by higher expected rate of return on equity and therefore overall cost of capital remains constant.



**Fig.5.2. Behaviour of  $K_e$ ,  $K_w$  and  $K_d$  under Net operating Income approach.**

It is clear from the diagram 4.2 that with increase to financial leverage, the overall cost of capital ( $K_o$ ) and cost of debt ( $K_d$ ) remains at the same level but cost of equity increases with increase in financial leverage. This is because the expected rate of return on equity increases with the increase in financial risk in the business. Overall cost of capital remains constant because the benefit of low cost of debt is neutralized by increase in the cost of equity.

**Optimum capital structure under NOI Approach:** As per NOI approach the cost of debt, market value of the firm and the market value of the equity shares remain constant irrespective of change in the financial leverage and the benefit of low cost of debt is offset by the increased rate of return on equity with the increase in debt in the capital structure. Therefore, the overall all cost of capital remains the same at any level of debt; hence, the capital structure is optimum at any level of debt-equity mix.

**Criticisms of NOI approach** The NOI approach is criticized on the following grounds:

- (i) The assumption of absence of corporate tax is not correct.
- (ii) The cost of debt increases with the increase in the quantum of debt.
- (iii) As the cost of debt increases with the increase in financial leverage, the overall cost of capital also increases with increase in financial leverage.



(iv) An investor values differently the firm having higher level of debt in its capital structure than the firm having less debt or no debt.

### Example NOI Approach

Net Operating Income or EBIT Rs. 30,000

Total Value of Capital Structure Rs. 2,00,000.

Cost of Debt Capital  $K_d$  10%

Average Cost of Capital  $K_w$  12%

Calculate Cost of Equity,  $K_e$ : value of the firm  $V$  applying NOI approach under each of the following alternative leverages:

Leverage (debt to total capital) 0%, 20%, 50%, 70%, and 100%

#### Solution :

Statement Showing the Cost of Equity and the Value of the Firm

Degree of Leverage	0	0.2	0.5	0.7	1.0
	Rs.	Rs.	Rs.	Rs.	Rs.
Equity Capital	2,00,000	1,60,000	1,00,000	60,000	—
Debt Capital	—	40,000	1,00,000	1,40,000	2,00,000
Total	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>
EBIT	30,000	30,000	30,000	30,000	30,000
Less : Interest on Debt Capital (10%)	—	4,000	10,000	14,000	20,000
Earnings to Equity	<u>30,000</u>	<u>26,000</u>	<u>20,000</u>	<u>16,000</u>	<u>10,000</u>
Value of firm (V)					
$V = \frac{EBIT}{K_w}$	2,50,000	2,50,000	2,50,000	2,50,000	2,50,000
Less : Value of Debt (T)	—	40,000	1,00,000	1,40,000	2,00,000
Value of Equity (S)	<u>2,50,000</u>	<u>2,10,000</u>	<u>1,50,000</u>	<u>1,10,000</u>	<u>50,000</u>
Thus,					
$(K_d)$ Given	10%	10%	10%	10%	10%
$(K_e)$ Given	12%	12%	12%	12%	12%
$(K_e) \left( \frac{EBIT}{S} \right)$	12%	12.4%	13.3%	14.5%	20%

Although the value of the firm, Rs. 2,50,000 is constant at all levels, the cost of equity is increased with the corresponding increase in leverage. Thus, if the cheaper debt capital is used, that will be offset by the increase in the total cost of equity  $K_e$ , and, as such, both  $K_e$  and  $K_d$  remain unchanged for all degrees of leverage, i.e. if cheaper debt capital is proportionately increased and used, the same will offset the increase of cost of equity.

### 3. Traditional Theory Approach:

According to this approach weighted average cost of capital decreases only up to a certain level of financial leverage and starts increasing beyond certain level of judicious mix of debt and equity. Hence, a firm has an optimum capital structure when the weighted average cost of capital is minimum and the market value of the firm is maximum.

This approach has main three stages

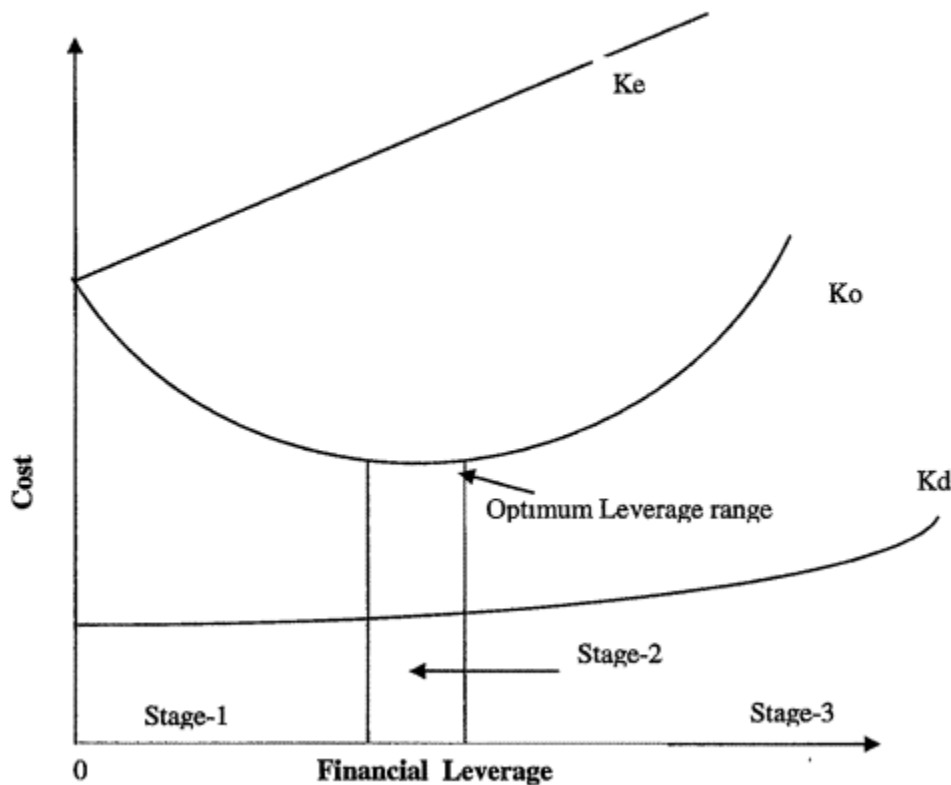
**First Stage: Increasing Value** In the first stage the cost of equity ( $k_e$ ) either remains constant or rises slightly with increase in debt. At this stage, the increase in cost of equity is less than the advantage in cost due to lower cost of debt than equity. During this stage, the cost of debt ( $k_d$ ) remains constant since, it is considered as a rational decision. Consequently, the overall cost of capital ( $k_o$ ) decreases with increase in leverage and thus the total value of the firm ( $V$ ) also increases.

**Second Stage: Optimum Value** At this stage, the cost of equity increases faster than it increases at the first stage when debt is increased. Further the benefit of low cost of debt is wiped off by increase in cost of equity beyond certain level, hence, the firm reaches at a stage of minimum weighted average cost of capital and maximum value of the firm at certain level of debt equity mix where the optimum capital structure is attained.

**Third Stage: Declining Value** As the debt is increased beyond certain level, the increase in cost of equity becomes greater than the advantage of low cost of debt and therefore weighted average cost of capital increases and the market value of the firm decreases. At this stage, the value of the firm goes on declining with every increase in debt replacing the equity. This happens because investors perceive a higher degree of financial risk and demand a higher rate of return on equity, which exceeds the advantage of low cost debt.

These three stages are explained with the help of diagram as under:

### Effect of Financial Leverage on Cost of Equity, Cost of Debt and Over all Cost of Capital under Traditional Approach



The cost of capital curve is convex to the x axis which shows that in the beginning when there is no debt or a little debt; the cost of capital is higher; as more debt is introduced it goes on declining and there is a specific point at which the cost of capital is minimum and after this point the cost of capital starts increasing with the introduction of more and more debt in the capital structure. As per this theory, the optimal Capital Structure would fall somewhere in the second stage.

### Optimum Capital Structure under Traditional Approach

The supporters of traditional theory believe that overall cost of capital declines when the debt is used in capital structure and it is possible to attain optimum capital structure. The capital structure is optimum at the stage of debt-equity mix where the cost the over all cost of capital is minimum and the value of the firm is maximum.

## Criticisms of traditional Approach:

The traditional theory is criticized on following grounds;

- (i) The theory assumes that investors value the levered firms more than the unlevered firm is not practically correct.
- (ii) Risk for shareholders does not increase with additional debt for financially sound firms.
- (iii) Investor's perception about risk of leverage does not change for the same firm at different levels of leverage.
- (iv) Optimum capital structure is affected by tax deductibility of interest and other capital market factors, which are ignored.

## Example traditional approach

EBIT	
Total value of	Rs. 30,000
Capital Structure	Rs. 2,00,000

Cost of Equity		Cost of Debt	
Upto Rs. 1,00,000	@ 15%	Upto Rs. 1,00,000	@ 10%
Between Rs. 1,00,000 and Rs. 1,50,000	@ 18%	Between Rs. 1,00,000 and Rs. 1,50,000	@ 12%
Between Rs. 1,50,000 and Rs. 2,00,000	@ 20%	Between Rs. 1,50,000 and Rs. 2,00,000	@ 15%

Calculate the cost of capital and the value of the firm under each of the following alternative degree of leverage and comment on them.

$$\text{Leverage} : \left( \frac{\text{Debt}}{\text{Total Capital}} \right) = 0\% \quad 20\% \quad 50\% \quad 70\% \quad 100\%$$

**Statement showing the Cost of Capital and the value of the firm.**

Leverage	0	0.2	0.5	0.7	1.0
given —					
$K_d$	10%	10%	10%	12%	15%
$K_e$	15%	15%	15%	18%	20%
$K_w = \left(\frac{T}{V}\right) K_d + \left(\frac{S}{V}\right) K_e$	30%	28%	25%	27.6%	30%
EBIT	30,000	30,000	30,000	30,000	30,000
Less : Interest on Debt ( $K_d \times T$ )	—	4,000	10,000	16,800	30,000
Earnings to Equity (EBIT – I)	30,000	26,000	20,000	13,200	—
Amount of Debt (T)	—	40,000	1,00,000	1,40,000	2,00,000
Value of Equity $\left(\frac{EBIT}{K_e}\right) =$	2,00,000	1,73,333	1,33,333	73,333	—
Total Value of the firm ( $V = T + S$ )	2,00,000	2,13,333	2,33,333	2,13,333	2,00,000

\*(i) When financing leverage is 0

$$K_w = \left(\frac{T}{V}\right) K_d + \left(\frac{S}{V}\right) K_e$$

$$= .0 \times 10 + 2 \times 15 = 30\%$$

(ii) When financing leverage is .2

$$= .4 \times 10 + .16 \times 15 = 28\%$$

(iii) When financing leverage is .5

$$= .10 \times 10 + .10 \times 15 = 25\%$$

(iv) When financing leverage is .7

$$= .14 \times 12 + .6 \times 18 = 27.6\%$$

(v) When financing leverage is 1.0

$$= 2.0 \times 15 + 0 \times 20 = 30\%$$

#### 4. MODIGLIANI AND MILLER APPROACH

This approach was devised by Modigliani and Miller during the 1950s. The fundamentals of the Modigliani and Miller Approach resemble that of the [Net Operating Income](#) Approach. Modigliani and Miller advocate capital structure irrelevancy theory, which 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 in the financing mix has no bearing on the value of a firm.

The Modigliani and Miller Approach further states that the market value of a firm is affected by its operating income, apart from the risk involved in the investment. The theory stated that the value of the firm is not dependent on the choice of capital structure or financing decisions of the firm.

## 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.

The Modigliani and Miller Approach indicates that the value of a leveraged firm (a firm that has a mix of debt and equity) is the same as the value of an unleveraged firm (a firm that is wholly financed by equity) if the operating profits and future prospects are same. That is, if an investor purchases shares of a leveraged firm, it would cost him the same as buying the shares of an unleveraged firm.

**The following propositions outline the MM argument about the relationship between cost of capital, capital structure and the total value of the firm:**

- (i) The cost of capital and the total market value of the firm are independent of its capital structure. The cost of capital is equal to the capitalisation rate of equity stream of operating earnings for its class, and the market is determined by capitalizing its expected return at an appropriate rate of discount for its risk class.
- (ii) The second proposition includes that the expected yield on a share is equal to the appropriate capitalisation rate for a pure equity stream for that class together with a premium for financial risk equal to the difference between the pure-equity capitalisation rate ( $K_e$ ) and yield on debt ( $K_d$ ). In short, increased  $K_e$  is offset exactly by the use of cheaper debt.
- (iii) The cut-off point for investment is always the capitalisation rate which is completely independent and unaffected by the securities that are invested.

## Topic 4 Financing Decision

### Financing Decisions

If carefully reviewed what constitutes a business, we will come to the conclusion that there are two things that matter, money and decision. Without money, a company won't survive and without decisions, money can't survive. An administration has to take countless decisions in the lifetime of the company. Thus, the most important ones are related to money. The decisions related to money are called 'Financing Decisions.'

There are three decisions that financial managers have to take:

- Investment Decision
- Financing Decision and
- Dividend Decision

### Investment Decision

These are also known as Capital Budgeting Decisions. A company's assets and resources are rare and must be put to their utmost utilization. A firm should pick where to invest in order to gain the highest conceivable returns. This decision relates to the careful selection of assets in which funds will be invested by the firms. The firm puts its funds in procuring fixed assets and current assets. When choice with respect to a fixed asset is taken it is known as capital budgeting decision.

### Factors Affecting Investment Decision

- *Cash flow of the venture*: When an organization starts a venture it invests a huge capital at the start. Even so, the organization expects at least some form of income to meet everyday day-to-day expenses. Therefore, there must be some regular cash flow within the venture to help it sustain.
- *Profits*: The basic criteria for starting any venture is to generate income but moreover profits. The most critical criteria in choosing the venture are the rate of return it will bring for the organization in the nature of profit for, e.g., if venture A is getting 10% return and venture B is getting 15% return then one must prefer project B.

- *Investment Criteria:* Different Capital Budgeting procedures are accessible to a business that can be utilized to assess different investment propositions. Above all, these are based on calculations with regards to the amount of investment, interest rates, cash flows and rate of returns associated with propositions. These procedures are applied to the investment proposals to choose the best proposal.

## **Financing Decision**

Financial decision is important to make wise decisions about when, where and how should a business acquire fund. Because a firm tends to profit most when the market estimation of an organization's share expands and this is not only a sign of development for the firm but also it boosts investor's wealth. Consequently, this relates to the composition of various securities in the capital structure of the company.

### Factors affecting Financing Decisions

- *Cost:* Financing decisions are all about allocation of funds and cost-cutting. The cost of raising funds from various sources differ a lot. The most cost-efficient source should be selected.
- *Risk:* The dangers of starting a venture with the funds from various sources differ. Larger risk is linked with the funds which are borrowed, than the equity funds. This risk assessment is one of the main aspects of financing decisions.
- *Cash flow position:* Cash flow is the regular day-to-day earnings of the company. Good or bad cash flow position gives confidence or discourages the investors to invest funds in the company.
- *Control:* In the situation where existing investors need to hold control of the business then finance can be raised through borrowing money, however, when they are prepared for diluting control of the business, equity can be utilized for raising funds. How much control to give up is one of the main financing decisions.
- *Condition of the market:* The condition of the market matter a lot for the financing decisions. During boom period issue of equity is in majority but during a depression, a firm will have to use debt. These decisions are an important part of financing decisions.

## **Dividend Decision**

Dividends decisions relate to the distribution of profits earned by the organization. The major alternatives are whether to retain the earnings profit or to distribute to the shareholders.



## Factors Affecting Dividend Decisions

- *Earnings*: Returns to investors are paid out of the present and past income. Consequently, earning is a noteworthy determinant of the dividend.
- *Dependability in Earnings*: An organization having higher and stable earnings can announce higher dividend than an organization with lower income.
- *Balancing Dividends*: For the most part, organizations attempt to balance out dividends per share. A consistent dividend is given every year. A change is made, if the organization's income potential has gone up and not only the income of the present year.
- *Development Opportunity*: Organizations having great development openings if they hold more cash out of their income to fund their required investment. The dividend announced in growing organizations is smaller than that in the non-development companies.

## Other Factors

- *Cash flow*: Dividends are an outflow of funds. To give the dividends, the organization must have enough to provide them, which comes from regular cash flow.
- *Shareholders' Choices*: While announcing dividends, the administration must remember the choices of the investors. Some shareholders want at least a specific sum to be paid as dividends. The organizations ought to consider the preferences of such investors.
- *Taxes*: Compare tax rate on dividend with the capital gain tax rate that is applicable to increase in market price of shares. If the tax rate on dividends is lower, shareholders will prefer more dividends and vice versa.
- *Stock market*: For the most part, an expansion in dividends positively affects the stock market, though, a lessening or no increment may negatively affect the stock market. Consequently, while deciding dividends, this ought to be remembered.
- *Access to Capital Market*: Huge and organizations with a good reputation, for the most part, have simple access to the capital market and, consequently, may depend less on retained earnings to finance their development. These organizations tend to pay higher dividends than the smaller organizations.
- *Contractual and Legal Constraints*: While giving credits to an organization, once in a while, the lending party may force certain terms and conditions on the payback of

dividends in future. The organizations are required to guarantee that the profit payout does not abuse the terms of the loan understanding in any manner.