Unit 4th, Financial Management, BBA 4th

(Topic 1) Dividend Policy & Determinants of Dividend Policy

Dividend Policy

The term dividend refers to that part of profits of a company which is distributed by the company among its shareholders. It is the reward of the shareholders for investments made by them in the shares of the company. The investors are interested in earning maximum return to maximize their wealth.

A firm needs funds to meet its long-term growth. If a company pays most of the profit as dividend, then for business requirement or further expansion then it will have to depend on outsiders for funds. Such as issue of debt or new shares.

Firms decision to pay dividend in equitable proportion of dividend and retained earnings.

Determinants of Dividend Policy

1. Legal restrictions

Legal provision related to dividends are laid down in sec 93,205,205A, 206 and 207 of companies act.Dividend can be paid only out of current profit or past profit after providing depreciation Company providing more than 10% dividend to transfer certain percentage of current year profit to reserves.

2**. Magnitude and trend of earnings**

The amount and trend of earnings is an important in dividend policy. Dividend can be paid only out of present or past year's profit; earnings of a company fix the upper limit on dividends. Past trend is kept in mind while decision dividend decision .

3**. Desire and type of shareholders**

Discretion to declare dividend or not is decided by the board of directors. Directors give importance to the desire of the shareholder in declaration of dividends. Desire for dividend depends on their economic status. Investor such as retired person, widows and other economically weaker person view dividend as a source of funds to meet their day-to-day living expenses – the company will pay regular dividend. Investor with high income tax bracket will not prefer current dividend they will expect only capital gains.

4. Nature of industry

Nature of industry to which the company is engaged also affects dividend policy. Certain industry has steady and stable demand irrespective of prevailing economic condition. Eg : people used to drink liquor both in boom and in recession. Such firm gets regular earning and hence follows consistent dividend policy. Earning are uncertain in such case conservative dividend policy is used. Such firms should retain substantial part of their current earnings during boom period in order to provide funds to pay dividends in recession period

5. Age of the company

Age also influence the dividend decision of the company. Newly established concern has limit in payment of dividend and retain substantial part for financing future growth and development Older company has sufficient reserves can pay liberal dividends.

6. Future financial requirement

Future financial requirement is to be considered while deciding dividend. Company has profitable investment opportunities then the firm will pay limited amount as dividend and invest the remaining amount. If there is no investment opportunities then the company will pay more dividend

7. Government economic policy

The dividend policy of a firm has also to be adjusted to the economic policy of the government In 1974 and 1975 companies were allowed to pay dividends not more than 33 % of their profits or 12% on paid-up value of the shares, whichever was lower

8. **Taxation policy**

A high or low rate of business taxation affect the net earnings of company and thereby its dividend policy. A firm‘s dividend policy may be dictated by the income-tax status of its shareholders. If the dividend income of shareholders is heavily taxed being in high income bracket, then the shareholder will prefer capital gains and bonus shares.

(Topic 2) Walter's Model

Definition: According to the **Walter's Model**, given by prof. James E. Walter, the dividends are relevant and have a bearing on the firm's share prices. Also, the investment policy cannot be separated from the dividend policy since both are interlinked.

Walter's Model shows the clear relationship between the return on investments or internal rate of return (r) and the cost of capital (K). The choice of an appropriate dividend policy affects the overall value of the firm. The efficiency of dividend policy can be shown through a relationship between returns and the cost.

- If **r>K,** the firm should retain the earnings because it possesses better investment opportunities and can gain more than what the shareholder can by re-investing. The firms with more returns than a cost are called the "Growth firms" and have a zero payout ratio.
- If **r<K,** the firm should pay all its earnings to the shareholders in the form of dividends, because they have better investment opportunities than a firm. Here the payout ratio is 100%.
- If **r=K,** the firm's dividend policy has no effect on the firm's value. Here the firm is indifferent towards how much is to be retained and how much is to be distributed among the shareholders. The payout ratio can vary from zero to 100%.

Assumptions of Walter's Model

1. All the financing is done through the retained earnings; no external financing is used.
2. The rate of return (r) and the cost of capital (K) remain constant irrespective of any changes in the investments.
3. All the earnings are either retained or distributed completely among the shareholders.
4. The earnings per share (EPS) and Dividend per share (DPS) remains constant.
5. The firm has a perpetual life.

Criticism of Walter's Model

1. It is assumed that the investment opportunities of the firm are financed through the retained earnings and no external financing such as debt, or equity is used. In such a case either the investment policy or the dividend policy or both will be below the standards.

2. The Walter's Model is only applicable to all equity firms. Also, it is assumed that the rate of return (r) is constant, but, however, it decreases with more investments.
3. It is assumed that the cost of capital (K) remains constant, but, however, it is not realistic since it ignores the business risk of the firm, that has a direct impact on the firm's value.

Note: Here, the cost of capital (K) = Cost of equity (Ke), because no external source of financing is used.

(Topic 3) Working capital and its types

Meaning of Working capital

- Working Capital is the amount of Capital that a Business has available to meet the day-to-day cash requirements of its operations

- Working Capital is the difference between resources in cash or readily convertible into cash (Current Assets) and organizational commitments for which cash will soon be required (Current Liabilities) .It refers to the amount of Current Assets that exceeds Current Liabilities (i.e. CA - CL)

- Working Capital refers to that part of the firm's Capital, which is required for Financing Short-Term or Current Assets such as Cash, Marketable Securities, Debtors and Inventories.

Concepts of Working Capital:-

There are two concepts of working capital-

(1) Gross Working Capital Concept

(2) Net Working Capital Concept.

(1) Gross working capital:

Gross working capital; refers to firm's investment in currentassets. Current assets are the assets which can be converted into cash within an accounting year and include cash, short-term securities, debtors, bill receivables and stock.

According to this concept, working capital means Gross working Capital which is the total of all current assets of a business. It can be represented by the following equation:

Gross Working Capital = Total Current Assets

Definitions favoring this concept are:-

According to Mead, Mallot and Field :

"Working Capital means total of Current Assets".

(2) Net Working Capital Concept:

Net working capital refers to the difference between current assets and current liabilities.

Current liabilities are those claims of outsiders which are expected to mature for payment within an accounting year and include creditors, bills payables, and outstanding expenses.

Net working capital can bepositive or negative. A positive net working capital will arise when current assets exceed current liabilities. A negative Net working capital occurs when current liabilities are in excess of current assets.

Net Working Capital = Current Assets - Current Liabilities

Definitions Favoring Net Working Capital Concept:-

According to C.W.Gestenbergh

"It has ordinarily been defined as the excess of current assets over current liabilities".

According to Lawrence. J. Gitmen

" The most common definition of net working capital is the difference of firm's current assets and current liabilities".

<u>Classification of Working Capital</u>

(1) On the Basis of Concept: -

(i) Gross Working Capital

(ii) Net Working Capital

(2) On the Basis of time or Need:-

(i) Permanent Working Capital

(ii) Temporary Working Capital

II. On the basis of time or need

(1) Permanent or Fixed Working Capital:-

The need for working capital fluctuates from time to time. However, to carry on day-to-day operations of the business without any obstacles, a certain minimum level of raw materials, work-in-progress, finished goods and cash must be maintained on a continuous basis. The amount needed to maintain current assets on this minimum level is called permanent or regular working capital.

The amount involved as permanent working capital has to be meet from long-term sources of finance, e.g.

(i) Capital

(ii) Debentures

(iii) Long-term loans.

(2) Temporary or Variable or Fluctuating Working Capital:-

Depending upon the changes in production and sales, the need for working capital, over and above the permanent level of working capital is called temporary, fluctuating or variable working capital. It may be two types:-

(a)Seasonal-Due to seasonal changes, level of business activities is higher than normal during some months of year and therefore additional working capital will be required along with the permanent working capital. It is so because during peak season, demand rises and more stock is to be maintained to meet the demand .

(b) Special- Additional doses of working capital may be required to face cut throat competition in the market or other contingencies like strikes, lock outs, theft etc.

(Topic 5) ADEQUATE WORKING CAPITAL:

The firm should maintain a sound working capital
position. It should have adequate working capital to run its business operations. Both excessive as well as inadequate working capital positions are dangerous from firm's point of view. Excessive working capital means holding costs and idle funds which earn no profit for the firm. Paucity of working capital not only impairs the firm's profitability but also results in production interruptions and inefficiencies and sales disruption

<u>**Importance/Need/Advantage of Adequate Working Capital:**</u>

(1) Availability of Raw Materials Regularly:-

Adequacy of working capital makes it possible for a firm to pay the suppliers of raw materials on time. As a result it will continue to receive regular supplies of raw materials and thus there will be no disruption in production process.

(2) Full Utilization of Fixed Assets:-

Adequacy of working capital makes it possible for a firm to utilize its fixed assets fully and continuously. For example, if there is inadequate stock of raw material, the machines will not be utilized in full and their productivity will be reduced.

(3) Cash Discount:-

A firm having the adequate working capital can avail the cash discount by purchasing the goods for cash or by making the payment before the due date.

(4) Increase in Credit Rating:-

Paying its short-term obligations in time leads to a strong credit rating which enables the firm to purchase goods on credit on favorable terms and to maintain its line of credit with banks etc. it facilities the taking of loan in case of need.

5) Exploitation of Favorable Market conditions:-

Whenever there are chances of increase in prices of raw materials, the firm can purchase sufficient quantity if it has adequate of working capital. Similarly, if a firm receives a bulk order for the supply of goods it can take advantage of such opportunity if it has sufficient working capital.

(6) Facility in Obtaining Bank Loans:-

Banks do not hesitate to advance even the unsecured loan to a firm which has the sufficient working capital. This is because the excess of current assets over current liabilities itself is a good security.

(7) Increase in Efficiency of Management:-

Adequacy of working capital has a favorable psychological effect on the managers. This is because no obstacle arises in the day-to-day business operations. Creditors, wages and all other expenses are paid on time and hence it keeps the morale of manager’s high

(8) Ability to face crisis:-

Adequate working capital enables a concern to face business crisis in emergencies such as depression. Because during such periods, generally, there is much pressure on working capital.

(9) Solvency of the business:-

Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

(10) Good will

Sufficient working capital enables a business concern to male prompt payments and hence helps in creating and maintaining good will.

(Topic 6) EXCESSIVE AND INADEQUATE WORKING CAPITAL:

A business enterprise should maintain adequate working capital according to the needs of its business operations. The amount of working capital should neither be excessive nor inadequate. If the working capital is in excess if its requirements it means idle funds adding to the cost of capital but which earn nom profits for the firm. On the contrary, if the working capital is short of its requirements, it will result in production interruptions and reduction of sales and, in turn, will affect the profitability of the business adversely.

<u>Disadvantage of Excessive Working Capital:-</u>

(1) Excessive Inventory:-

Excessive working capital results in unnecessary accumulation of large inventory. It increases the chances of misuse, waste, theft etc.

(2) Excessive Debtors:-

Excessive working capital will results in liberal credit policy which, in turn, will results in higher amount tied up in debtors and higher incidence of bad debts.

(3) Adverse Effect on Profitability:-

Excessive working capital means idle funds in the business which adds to the cost of capital but earns no profits for the firm. Hence it has a bad effect on profitability of the firm.

(4) Inefficiency of Management:-

Management becomes careless due to excessive resources at their command. It results in laxity of control on expenses and cash resources.

Disadvantage of Inadequate Working Capital:

(1) Difficulty in Availability of Raw-Material:-

Adequacy of working capital results in non-payment of creditors on time. As a result the credit purchase of goods on favorable terms becomes increasingly difficult. Also, the firm cannot avail the cash discount.

(2) Full Utilization of Fixed Assets not Possible:

Due to the frequent interruption in the supply of raw materials and paucity of stock, the firm cannot make full utilization of its machines etc.

(3) Difficulty in the Maintenance of Machinery:

Due to the inadequacy of working capital, machines are not cared and maintained properly which results in the closure of production on many occasions.

(4) Decrease in Credit Rating:

Because of inadequacy of working capital, firm is unable to pay its short-term obligations on time. It decays the firm's relations with its bankers and it becomes difficult for the firm to borrow in case of need.

(5) Non Utilization of Favorable Opportunities:

For example, a firm cannot purchase sufficient quantity of raw materials in case of sudden decrease in the prices. Similarly, if the firm receives a big order, it cannot execute it due to shortage of working capital.

(6) Decrease in Sales:

Due to the shortage of working capital, the firm cannot keep sufficient stock of finished goods. It results in the decrease in sales. Also, the firm will be forced to restrict its credit sales. This will further reduce the sales.

(7) Difficulty in the Distribution of Dividends:

Because of paucity of cash resources, firm will not be able to pay the dividend to its shareholders.

(8) Decrease in the Efficiency of Management:

It will become increasingly difficult for the management to pay its creditors on time and pay its day-to-day expenses. It will also be difficult to pay the wages regularly which will have an adverse effect on the morale of managers.

(Topic 7) DETERMINANTS OF WORKING CAPITAL:

A firm should have neither too much nor too little working capital. A large number of factors, each has a different importance, influencing working capital needs of firms. The importance of factors also changes for a firm over time.
Therefore, an analysis of relevant factors should be made in order to determine total investment in working capital. The following is the description of factors which generally influence the working capital requirements. The working capital requirement is determined by a large number of factors but, in general, the following factors influence the working capital needs of an enterprise:

(1) Nature of Business :-

Working capital requirements of an enterprise are largely influenced by the nature of its business. For instance, public utilities such as railways, transport, water, electricity etc. have a very limited need for working capital because they have invested fairly large amounts in fixed assets. Their working capital need is minimal because they get immediate payment for their services and do not have to
maintain big inventories. On the other extreme are the trading and financial enterprises which have to invest fewer amounts in fixed assets and a large amount in working capital. This is so because the nature of their business is such that they have
to maintain a sufficient amount of cash, inventories and debtors. Working capital needs of most of the manufacturing enterprises fall between these two extremes, that is, between public utilities and trading concerns.

(2) Size of Business:-

Larger the size of the business enterprise, greater would be the need for working capital. The size of a business may be measured in terms of scale of its business operations.

(3) Growth and Expansion:-

As a business enterprise grows, it is logical to expect that a larger amount
of working capital will be required. Growing industries require more working capital than those that are static.

(4) Production cycle:-

Production cycle means the time-span between the purchase of raw materials and its conversion into finished goods. The longer the production cycle, the larger will be the need for working capital because the funds will be tied up for a longer period in work in process. If the production cycle is small, the need for working capital will also be small.

(5) Business Fluctuations:-

Business fluctuations may be in the direction of boom and depression. During boom period the firm will have to operate at full capacity to meet the increased demand which in turn, leads to increase in the level of inventories and book debts. Hence, the need for working capital in boom conditions is bound to increase. The depression phase of business fluctuations has exactly an opposite effect on the level of working capital requirement.

(6) Production Policy:-

The need for working capital is also determined by production policy. The demand for certain products (such as woolen garments) is seasonal. Two types of production policies may be adopted for such products. Firstly, the goods may be produced in the months of demand and secondly, the goods may be produces throughout the year. If the second alternative is adopted, the stock of finished goods will accumulate progressively upto the season of demand which requires an increasing amount of working capital that remains tied up in the stock of finished goods for some months.

(7) Credit Policy Relating to Sales:-

If a firm adopts liberal credit policy in respect of sales, the amount tied up in debtors will also be higher. Obviously, higher book debts mean more working capital. On the other hand, if the firm follows tight credit policy, the magnitude of working capital will decrease

(8) Credit Policy Relating to Purchase:-

If a firm purchases more goods on credit, the requirement for working capital will be less. In other words, if liberal credit terms are available from the suppliers of goods (i.e., creditors), the requirement for working capital will be reduced and vice versa.

(9) Availability of Raw Material:-

If the raw material required by the firm is available easily on a continuous basis, there will be no need to keep a large inventory of such materials and hence the requirement of working capital will be less. On the other hand, if the supply of raw material is irregular, the firm will be compelled to keep an excessive inventory of such raw materials which will result in high level of working capital. Also, some raw materials are available only during a particular season such as oil seeds, cotton, etc. They would have to be necessarily purchased in that season and have to be kept in stock for a period when supplies are lean. This will require more working capital.

(10) Availability of Credit from Banks:-

If a firm can get easy bank facility in case of need, it will operate with less working capital. On the other hand, if such facility is not available, it will have to keep large amount of working capital.

(11) Volume of Profit:-

The net profit is a source of working capital to the extent it has been earned in cash. Higher net profit would generate more internal funds thereby contributing the working capital pool.

(12) Level of Taxes:-

Full amount of cash profit is not available for working capital purpose. Taxes have to be paid out of profits. Higher the amount of taxes less will be the profits for working capital.

(13) Dividend Policy:-

Dividend policy is a significant element in determining the level of working capital in an enterprise. The payment of dividend reduces the cash and thereby, affects the working capital to that extent. On the contrary, if the company does not pay dividend but retains the profits, more would be the contribution of profits towards capital pool.

(14) Depreciation Policy:-

Although depreciation does not result in outflow of cash, it affects the working capital indirectly. In the first place, since depreciation is allowable expenditure in calculating net profits, it affects the tax liability. In the second place, higher depreciation also means lower disposable profits and, in turn, a lower dividend payment. Thus, outgo of cash is restricted to that extent.

(15) Price Level Changes:-

Changes in price level also affect the working capital requirements. If the price level is rising, more funds will be required to maintain the existing level of production. Same level of current assets will need increased investment when prices are increasing. However, companies that can immediately their product prices with rising price levels will not face a severe working capital problem. Thus, it is possible that some companies may not be affected by rising prices while others may be badly hit.

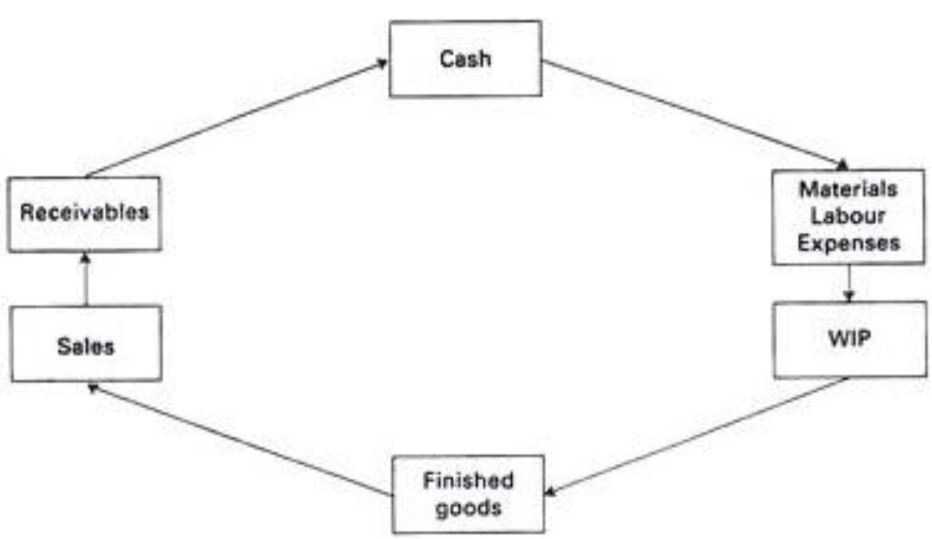
(16) Efficiency of Management:-

Efficiency of management is also a significant factor to determine the level of working capital. Management can reduce the need for working capital by the efficient utilization of resources. It can accelerate the pace of cash cycle and thereby use the same amount working capital again and again very quickly.

(Topic 8) Operating Cycle

Working capital is the life blood of any business, without which the fixed assets are inoperative. Working capital circulates in the business, and the current assets change from one form to the other. Cash is used for procurement of raw materials and stores items and for payment of operating expenses, then converted into work-in-progress, then to finished goods.

When the finished goods are sold on credit terms receivables balances will be formed. When the receivables are collected, it is again converted into cash. The need for working capital arises because of time gap between production of goods and their actual realization after sales. This time gap is called technically called as ‘operating cycle’ or ‘working capital cycle’.



The operating cycle of a company consists of time period between the procurement of inventory and the collection of cash from receivables. The operating cycle is the length of time between the company's outlay on raw materials, wages and other expenses and inflow of cash from sale of goods. Operating cycle is an important concept in management of cash and management of working capital.

The above said periods are ascertained as follows:

(a) Raw Material Holding Period:

$$\frac{\text{Average raw material stock}}{\text{Average consumption of raw material/365}}$$

(b) Work-In-Process Period:

$$\frac{\text{Average work} - \text{in} - \text{process}}{\text{Average cost of goods/365}}$$

(c) Finished Goods Holding Period:

$$\frac{\text{Average finished goods stock}}{\text{Average cost of goods sold/365}}$$

(d) Receivables Collection Period:

$$\frac{\text{Average nreceivables}}{\text{Average sales/365}}$$

(e) Creditors Payment Period:

$$\frac{\text{Average creditors}}{\text{Average purchase of raw materials/365}}$$

The length of operating cycle is the indicator of efficiency in management of short-term funds and working capital. The operating cycle calls for proper monitoring of external environment of the business. Changes in government policies like taxation, import restrictions, credit policy of central bank etc. will have impact on the length of operating cycle.

It is the task of Finance manager to manage the operating cycle effectively and efficiently. Based on the length of operating cycle, the working capital finance is done by the commercial banks. The reduction in operating cycle will improve the cash conversion cycle and ultimately improve the profitability of the firm.