Govt. Degree College for Men
Srikakulam

Dept. of Commerce & Management
N.Pavani, MBA., M.Com., M.Phil., APSET.

FINANCIAL MANAGEMNT

Introduction

Man is being a social animal needs money to live.

Money is earned - By doing some activities

Activities are - Resulted as businesses

To start business - Needs money as investment

No business can survive - Without profits

Profits are the reward for risk

Higher risk - Leads higher returns

Hence, management of finance is an essential ingredient in all the businesses.

Money - Finance - Investment

Money - **Currency as long as with you is money only**

Finance - **When you lend it to others to buy an asset / invest in investment it becomes finance**

Investment - **When you put the money anywhere as saving for earning return called investment.**

BUSINESS FINANCE
Vs
CORPORATE FINANCE

- **Business Finance is broader than Corporate Finance**

- **Business Finance covers sole proprietorship, partnership and company**

- **Corporate Finance is restricted only to the company finance.**

FINANCIAL MANAGEMENT

FM mainly involves raising of funds and their effective utilisation with the objective of maximising shareholders wealth.

In other words, financial management plays a key role in maximisation of the owner's wealth.

FM includes 3 A's :

- **A**nticipating financial needs
- **A**cquiring financial resources
- **A**llocating funds in business

Definition

According to Van Horne and Wachowicz,

“Financial Management is concerned with the acquisition, financing and management of assets with some overall goal in mind.”

In the words of Joseph and Massie,

“Financial Management is the operational activity of a business that is responsible for obtaining and effectively utilising the funds necessary for efficient operations.”

OBJECTIVES

- **Profit maximisation**
- **Wealth maximisation**

PROFIT MAXIMISATION

- **Maximum profit to be earned in a given period of time.**
- **Profit can be used in two senses :**

Owner oriented concept : refers to the amount of net profit to be distributed to the shareholders in the form of dividend.

Operational concept : is used to measure the economic efficiency of the enterprise.

Merits

- **Best criterion for decision making.**
- **Efficient allocation of scarce resources.**
- **Optimum utilisation of available resources.**
- **Ensures the welfare of share holders, creditors, higher wages, better quality, lower price goods and more employment opportunities.**

Limitations

- **Time factor ignored**
- **The term profit is used as vague.**
- **It ignores the risk factor**

Wealth Maximization

- **Also called value maximization.**
- **In simple words, wealth maximization means maximizing the present value of a course of action.**
- **It also takes care of**
  - ✓ **Lenders or Creditors**
  - ✓ **Workers or Employees**
  - ✓ **Public or Society**
  - ✓ **Customers**
  - ✓ **Management or Employer**
  - ✓ **Government**

SCOPE OF FINANCIAL MANAGEMENT

- Traditional Approach and Modern Approach

Traditional Approach

The scope of Financial Management is very narrow in sense

- Restricted only to the **"Procurement of funds".**
- It follows **Outsider-looking-in Approach and** deals with only outside investors, investment bankers.
- It fails to consider an important aspects i.e**. allocation of funds**.
- **The internal decision making** is completely ignored.
- It fails to consider the **problems involved in working capital** management.
- It neglected the issues relating to **the management of funds** and failed to make financial decisions.

Modern Approach

- **Conceptual and analytical frame work**
- **The modern approach is an analytical way of looking into financial problems of the firm.**
- ***Concerned with both acquisition/raising of funds as well as the allocation of funds to various uses.***

As per the modern approach Financial Management is concerned with the following Decisions/ Functions :

- **Investment Decisions**
- **Financing Decisions**
- **Dividend Decisions**

DECISIONS / FUNCTIONS OF FINANCE

Investment - **Capital Budgeting &** **Working Capital**

(Long Term) **&** **(Short Term)**

Financing - **Capital Structure, Cost of Capital & Leverages**

Dividend - **Stable Dividend, Optimum Dividend Policy**

Functions of Financial Management

Classified on the basis of the following :

Liquidity

- Forecasting cash flows
- Raising funds
- Managing the flow of internal funds

Profitability

- Cost control
- Pricing
- Forecasting future profits
- Measuring cost of capital

Management

- Management of long term funds
- Management of short term funds

ROLE OF A FINANCIAL MANAGER

To maximize 'value of the business' in the market the financial manager plays a critical role in any business enterprise.

- **What products to launch,**
- **How much amount needs to pay to develop those products,**
- **How much profits to keep and how to return profits to investors.**

In the corporation:

1. ***Make investment decisions,***
2. ***Make financing decisions, and***
3. ***Manage cash flow from operating activities.***

FUNCTIONS OF FINANCIAL MANAGER

The **top financial manager** within a firm is usually the **Chief Financial Officer** (CFO) then divided as **Treasurer & Controller**

Functions of a Controller

Controller is concerned with Accounting & Control.

- **The main functions of a Controller are**

  - Financial Accounting

  - Internal audit

  - Taxation

  - Management accounting & control

  - Budgeting & planning

Functions of a Treasurer

Treasurer is mainly responsible for financing & Investment activities.

- **The main functions of a treasurer are**

  -Obtaining finance

  - Investor relationship

  - Short term financing

  - Cash & credit mgt

  - Investments & insurance.

Basic Factors Determine The Value of the firm

- 1) Amount of
- 2) Timing of —— Expected cash flows
- 3) Risk of

In addition to the above -

- Economic Environment factors
- Decisions under management control
- Conditions in financial markets
- Competitive forces

INVESTMENT DECISION

- **Capital Budgeting**
- **Working Capital Management**

Investment Decision

- **Investment decision relates to selections of asset in which funds will be invested by a firm.**
- **The asset that can be acquired by a firm may be *long term asset or short term asset.***
- **Investment in long term assets is popularly known as "Capital Budgeting." It relates to management of fixed assets.**
- **Investment in current assets is popularly termed as "Working Capital Management". It relates to the management of current assets.**

Capital Budgeting

- Capital budgeting refers to planning the deployment of available capital for the purpose of maximizing the long term profitability of the firm.
- It is the firm's decision to invest its current funds most efficiently in long term activities in anticipation of flow of future benefits over a series of years.

Capital budgeting involves

- The search for new and more profitable investment proposals.
- The making of an economic analysis to determine the profit potential of each investment proposals.

Examples of capital projects include land, buildings, equipment and other major fixed asset items.

FEATURES

- Long term investment.
- High Risk.
- Irreversibility
- Series of returns

SIGNIFICANCE OF CAPITAL BUDGETING

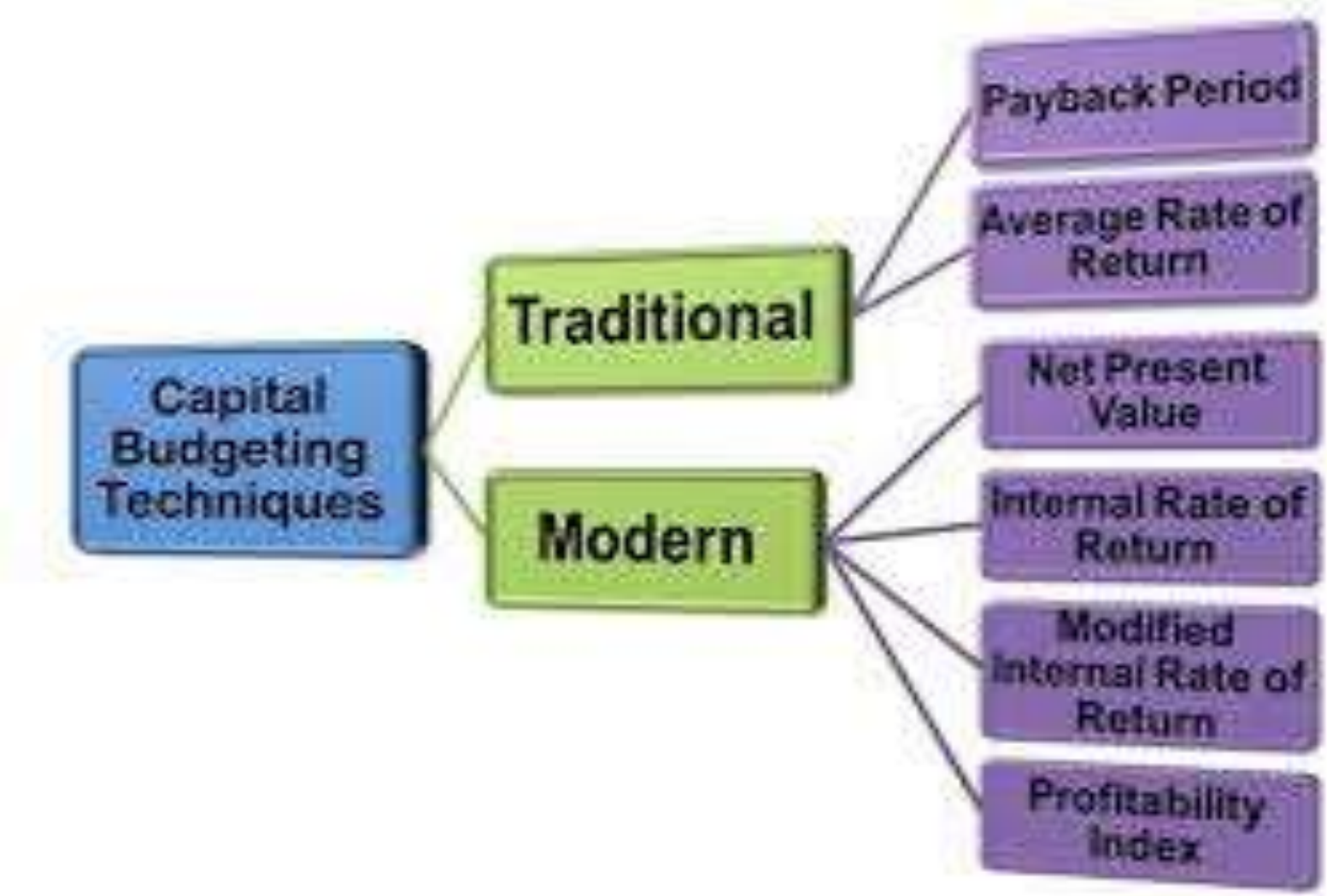
- **Growth**
- **More risky**
- **Huge investments**
- **Irreversibility**
- **Effect on other projects**
- **Difficult decisions**

PROCESS/STEPS OF CAPITAL BUDGETING

The process of capital budgeting divided into six broad steps

- **Planning/Idea generation**
- **Evaluation/Analysis**
- **Selection**
- **Financing of the project**
- **Execution/implementation**
- **Review of the project**

CAPITAL BUDGETING TECHNIQUES



Payback Period (PBP)

Period required to recover the original investment in a project.

Payback period can be calculated in two ways.

When Cash Flows are Equal/Even in Nature

Payback period = Original investment / Constant cash flows after taxes (**Or**)

Payback period =Initial investment (cash outlay) / Annual cash inflow

When Cash Flows are not equal / Uneven in Nature (Cumulative Cash Flows Method):

Payback period = Previous Years full recovery + (Unrecovered amount of investment / Cash flows during the year)

Advantages

- It is very simple and easy to understand.
- Cost involvement in calculating payback period is very less as compared to sophisticated methods.

Limitations

- It ignores the cash flows after payback period.
- It does not take into consideration time value of money.
- There is no rational basis for setting a minimum payback period.

Accounting Rate of Return/Average Rate of Return (ARR)

Accounting rate of return method *uses accounting information as revealed by financial statements*, to measure the profitability of the investment proposals.

ARR can be calculated in two ways:

$$\text{Accounting Rate of Return (ARR)} = \frac{\text{Average annual EAT or PA}}{\text{Original investment (OI)}} \times 100$$

OI = Original investment + Additional NWC + Installation charges + Transportation charge.

$$\text{Average rate of return} = \frac{\text{Average annual EAT}}{\text{Average Investment (AI)}} \times 100$$

AI = (Original investment - Scrap)1/2 + Additional NWC + Scrap value.

Advantages

- The most significant merit of ARR is that, it is very simple to understand and easy to calculate.
- Information can be easily being drawn from accounting records.
- It takes into account all profits of the projects life period.

Limitations

- It ignores the concept of time value of money.
- It doesn’t allow profits to be reinvested.
- It doesn’t differentiate between the sizes of the investment required for each project

Net Present Value Method

- The net present value method is one of the discounted cash flow methods.
- NPV can be defined as preset value of benefits minus preset value of costs.
- It is the process of calculating present value of cash inflows using cost of capital as an appropriate rate of discount and subtracts present value of cash out flows from the present value of cash inflows and finds the NPV, which may be positive or negative.

Advantages

- It takes into account the time value of money.
- It is particularly useful for selection of mutually exclusive projects.
- It takes into consideration the changing discount rate.

Limitations

- It is difficult to understand when compared with PBP and ARR.
- In case of projects involving different cash outlays, NPV method may not give dependable results.

Internal Rate of Return (IRR)

IRR is the discounting factor at which the PV of cash inflows equal to the PV of cash outflows.

Computation of IRR is based on the cash flows after taxes.

Generally, IRR may lie between two discounting factors.

It is also referred as *Trial & Error Method and Yield Method.*

$$IRR = LDF\% + \Delta DF \frac{LDPV - OI}{LDPV - HDPV}$$

Where, LDF = Discount factor of low trail.

Δ DF = Difference between low discounting factor and high discounting factor.

LDPV = PV of each inflows at low discounting factor trail.

HDPV = PV of cash inflows at high discounting factor trail.

OI = Original investment.

Advantages

- **IRR attempts to find the maximum rate of interest at which funds invested in the project could be repaid out of the cash inflows arising from that project.**
- **It considers the time value of money.**
- **It considers cash flows thought out the life of the project.**
- **It is consistent with the objective of shareholders wealth maximization.**

Limitations

- **Calculation of IRR is quite tedious and it is difficult to understand.**
- **It produces multiple rate of returns can be confusing.**

Profitability Index (PI) / Discounted Benefit Cost Ratio (DBCR)

It is also known as *discounted benefit cost ratio method*. It is similar to NPV method. It is the ratio of the present value of cash inflows, at the required rate of return, to initial cash outflow of the investment proposal.

PI method measures the present value of future cash per rupee, where as NPV is based on the difference between present value of cash inflows and present value of cash outflows.

PI = PV of cash inflows / Initial cash outlay

Advantages

- It gives due consideration to time value of money.
- It considers all cash flows to determine PI.
- It helps to rank projects according to their PI.

Limitations

- The information generated is based on estimates instead of facts.
- It may not provide correct decision-making criteria for certain projects.
- The tool ignores what is called the “sunk cost.”
- It can be difficult to estimate opportunity costs.

Capital Rationing

Capital rationing is the process of allocating the shortage of funds to the projects that provide acceptable / high returns

Assumptions of Capital Rationing

- **Availability of Limited Funds**: **While capital rationing, it is always assumed that the company has an inadequate amount of capital to undertake all the projects.**
- **Capital Expenditure Restrictions**: **It is presumed that due to the limited availability of capital or budgeting restrictions, the capital expenditure needs to be controlled.**
- **Optimal Return on Investment (ROI)**: **By using various mathematical concepts or trial and error method, the organization has to figure out the selection of projects which provide the best ROI.**

Advantages of Capital Rationing

- **Project Management**: Capital rationing ensures the selection of the most suitable and limited number of projects, which are easy to handle.
- **Ensures Higher Stability**: With limited project undertaking, the organization can maintain surplus funds for rainy days.
- **Capital Budgeting**: It is one of the most effective ways of optimizing the capital budget, through proper utilization of the owned and borrowed funds.
- **Focus on Higher Returns**: With the help of this strategy, the organizations can pick the most profitable projects by eliminating the ones with low ROI.
- **Avoids Wastage of Resources**: It prevents the company from investing in all those projects which looks rewarding.

Disdvantages of Capital Rationing

- **Going for Small Projects**: Due to limited funds, capital rationing sometimes leads to opting for small projects which may not be very profitable in the long run.
- **Violates Efficient Capital Market Theories**: The efficient capital market theory suggests that, all the projects which hike the shareholders' wealth and ensure value addition, should be selected.
- **No Intermediate Cash Flows**: Only the final ROI is considered in this technique; however, the in-between cash flows are avoided.
- **False Estimation of Cost of Capital**: If the cost of capital is not determined accurately, it may result in ineffective capital rationing and investment in inappropriate projects.
- **Non-maximization of Net Present Value**: Even if all the projects show high profitability indices, capital rationing limits their selection. Thus, it confines the scope of a higher NPV.

WORKING CAPITAL MANAGEMENT

INTRODUCTION

- The term 'working capital management' primarily refers to **the efforts of the management towards effective management of current assets and current liabilities**. ... In other words, ensuring sufficient liquidity in the business to be able to satisfy short-term expenses and debts.
- Working capital refers to the funds required for short term purposes or
- For meeting day to day expenses of business.
- It is a short term finance which is used to invest in current assets
- It is also called **Revolving Capital / Rotating Capital / Short Term Capital**

CONCEPTS OF WORKING CAPITAL

1. **Gross working capital**

Total investments in current assets

2. **Net working capital**

Difference between current assets and current liabilities

Current assets - Converted into cash within one year

Ex: Cash, bank, debtors, bills receivables, stock, short term securities or marketable securities and accounts receivables and prepaid expenses.

Current liabilities - Nature of payment within one year.

Ex: Creditors, bills payable, and bank over draft, accounts

OBJECTIVES OF WORKING CAPITAL

- **To ensure optimum investment in current assets.**
- **To strike a balance between the twin objectives of liquidity and profitability in the use of funds**
- **To ensure adequate flow of funds for current operations.**
- **To speed up the flow of funds or to minimize the stagnation of funds**

IMPORTANCE OF WORKING CAPITAL

- **Improves liquidity and solvency position**
- **Ensures continuity in business operations**
- **Increase productivity and profitability**
- **Enhance goodwill of the business**
- **Improves credit worthiness**
- **Timely payment of dividends**

SOURCES OF WORKING CAPITAL

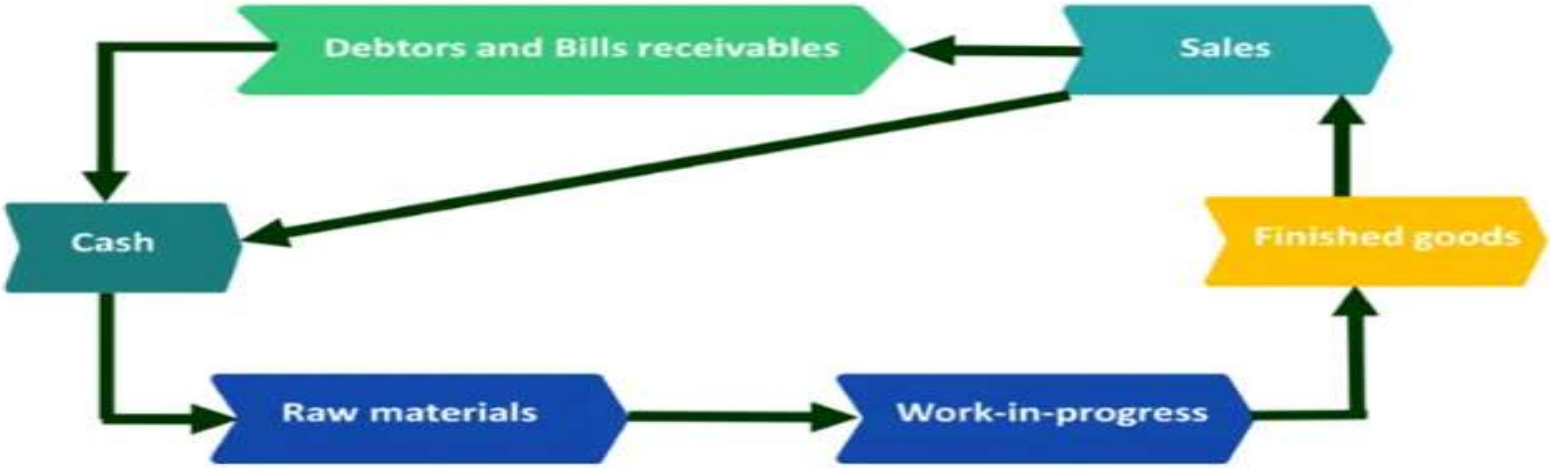
- **Loans from financial institutions**
- **Floating of debentures**
- **Accepting public deposits**
- **Funds through internal sources (profits)**

FACTORS INFLUENCING WORKING CAPITAL REQUIREMENTS

- Nature of business
- Operating efficiency
- Production policies
- Manufacturing firm
- Operating cycle
- Terms of purchases and sales
- Growth and expansion of business
- Scarce availability of raw materials
- Business cycle
- Level of taxes
- Size of business

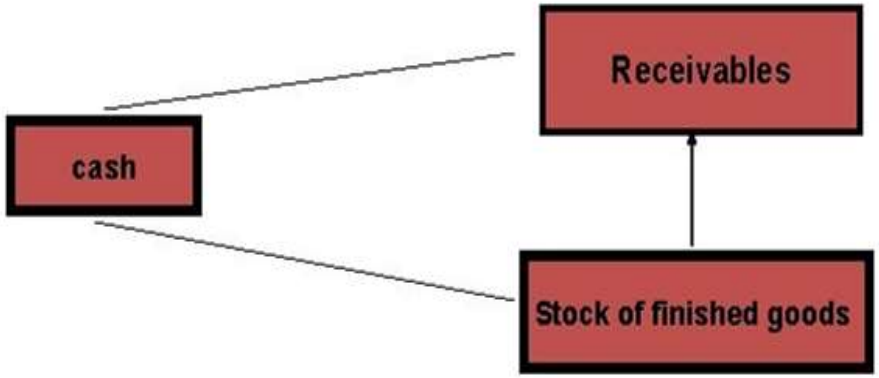
WORKING CAPITAL CYCLE / OPERATING CYCLE

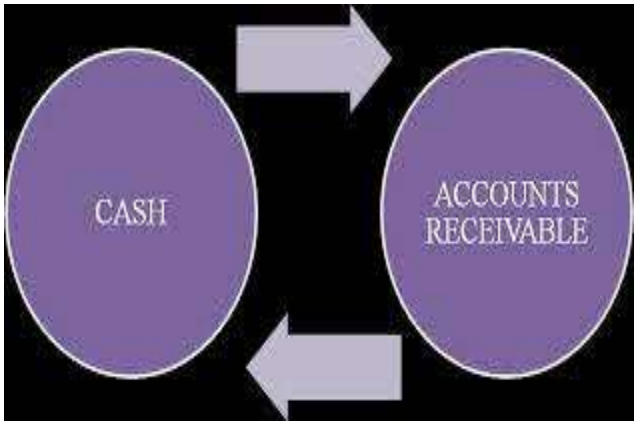
Manufacturing Firm



Non-Manufacturing Firm

Service





KINDS OF WORKING CAPITAL

- **Fixed working capital or permanent working capital**
- **Variable working capital or temporary working capital**

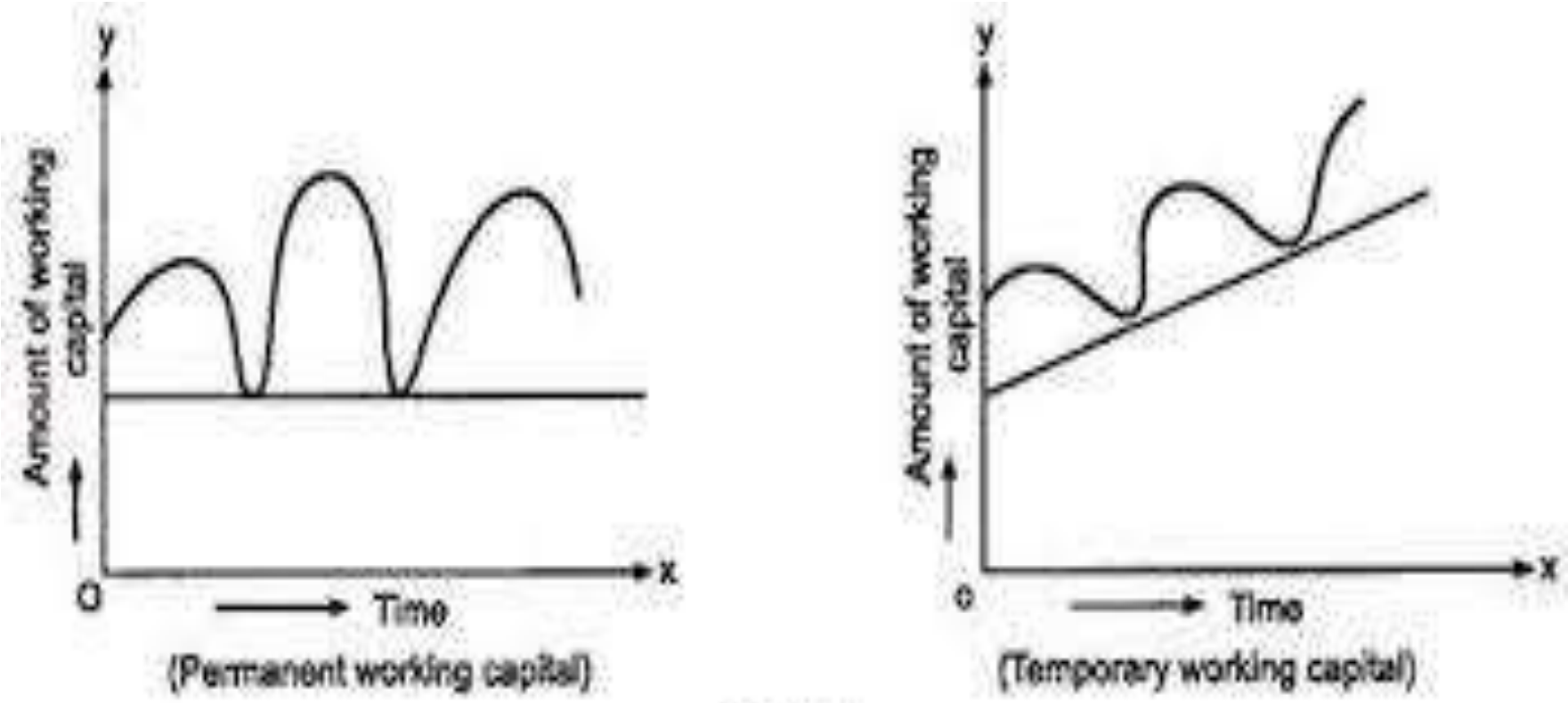
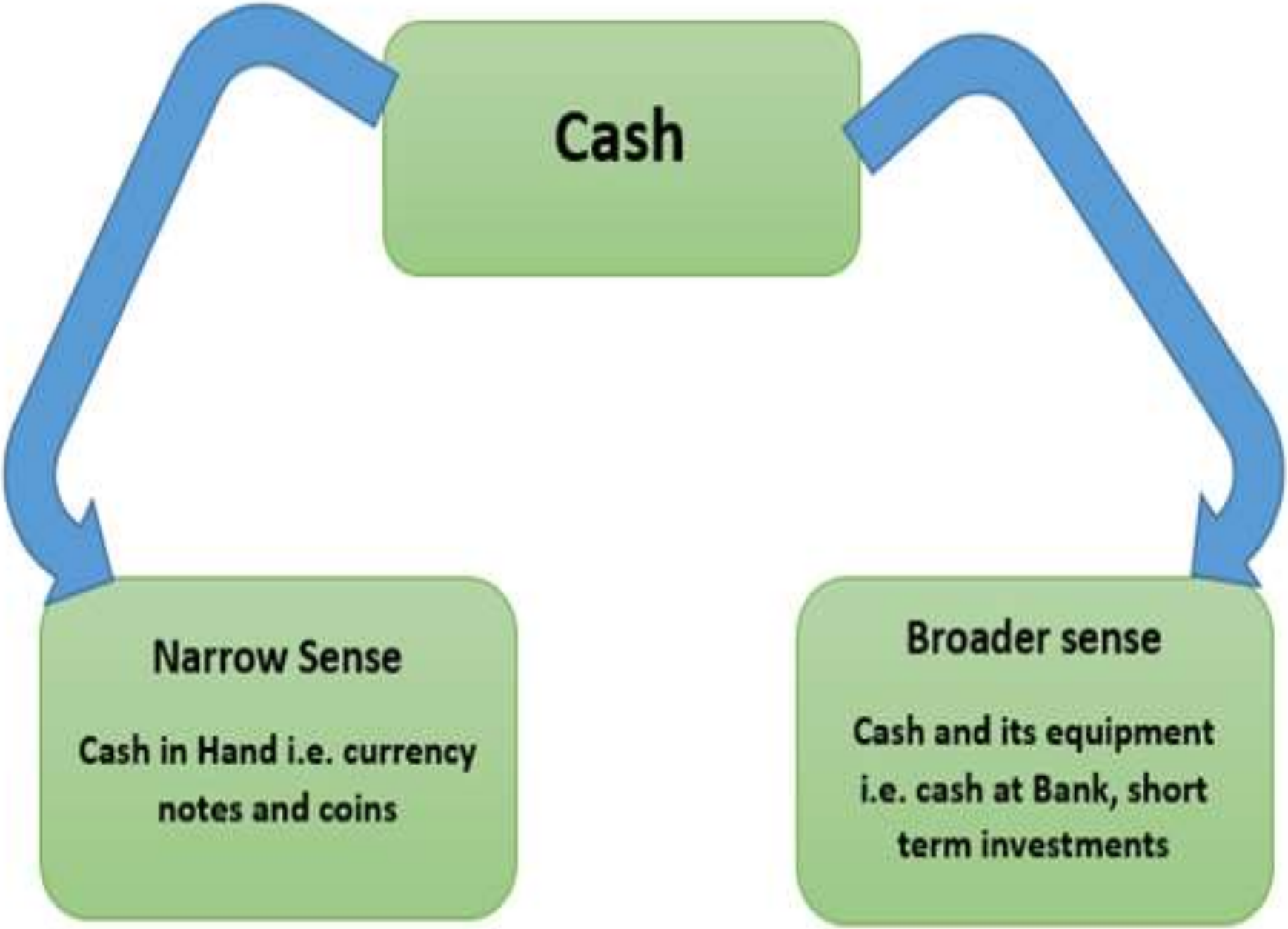


Fig. 1.1


Cash
Management

INTRODUCTION

- **Cash is most liquid asset.**
- **Cash is the common denominator to which all current assets. i.e., receivables & inventory get converted into cash.**
- **Cash management refers to management of cash inflows and cash outflows.**
- **In other words, It is the process that involves collecting and managing cash flows from the operating, investing, and financing activities of a company.**
- **Cash management also known as Treasury Management**


Cash
Narrow Sense
Cash in Hand i.e. currency notes and coins
Broader sense
Cash and its equipment i.e. cash at Bank, short term investments

MOTIVES FOR HOLDING CASH

- **Transaction motive – Routine cash needs**
- **Precautionary motive – Unexpected Expenses**
- **Speculative motive - Unexpected Moments**
- **Compensation motive – Minimum Cash balance at Banks**

MANAGEMENT OF CASH COLLECTIONS

- **Cash discount**
- **Concentration banking** – through no. of collection centres
- **Lock box system** - Lock box banking is the service provided by banks to companies for the receipt of payments from customers through a special post office box (safe deposit box)

RECEIVABLES MANAGEMENT

Management of receivables refers **to planning and controlling of debt owed to the customer on account of credit sales**.

Objectives

- **To increase the volume of sales.**
- **To ensure adequate flow of cash from trade debtors to meet current obligations.**
- **To facilitate liberal credit transactions.**
- **To settle trade debts without loss.**
- **To minimize the cost and risk involved in trade credit planning and control.**
- **To ensure credit worthiness/financial soundness of the concern.**
- **To take maximum advantages of trade discount and cash discount facilities.**

ADVANTAGES

- Helps to increase the operating profit because of more credit sales.
- Liberalize credit policy helps to increase the growth of sales.
- Credit policy helps to meet the competition.
- It helps to minimize the bad debts without taking stringent measures.
- It facilitates adequate working capital to meet its current obligations.
- It helps to make effective co-ordination between finance production, sales, profit and cost.

DECISION AREAS IN RECEIVABLES MANAGEMENT

- Credit Standards
- Credit Terms
- Collection Policies

Credit Standards

Credit standards represent the minimum criterion for the extension of credit to customers.

The trade-off with respect to credit standards cover:

- Collection cost
- Average collection period
- Bad debts
- Level of sales

Credit Terms

Credit terms defined as the stipulations under which goods are sold on credit. The credit terms have three components:

- Credit period
- Cash discount
- Cash discount period

Collection Policies

Refers to the procedure followed to collect the receipts when they become due after expiry of the credit period. The effects of tightening the collection policies would be:

- Decline in bad debts
- Decline in collection period
- Increase in collection cost and
- Decline in sales
- The effects of lenient policy would be exactly the opposite.

FACTORS INFLUENCING SIZE OF INVESTMENT IN RECEIVABLES

- Volume of credit sales
- Credit policy of the firm
- Trade terms
- Seasonality of business
- Collection policy
- Bill discounting and endorsement

FINANCING DECISION

Capital structure

Leverage analysis

Cost of capital

Financing Decision

Financing decision is concerned with determination of proportion of debt and equity in capital structure.

- ➔ **It is related to the financing mix or capital structure or leverage.**
- ➔ **Financial manager has to determine the proportion of debt and equity in capital structure.**
- ➔ **The two aspects of capital structure are:**
  - **Capital structure theories and**
  - **Determination of optimum capital structure.**

Capital Structure

The term capital structure refers to the mix of long term sources of funds, such as equity shares capital, reserve and suppliers, debentures, long term debt from outside sources and preference share capital.

Capital structure = Long term debt + Preferred stock + Net worth Or

Capital structure = Total assets – Current Liabilities

Thus, the capital structure of a firm consists of the shareholders' funds and debt.

The capital structure of a company/firm plays a very important role in determining the value of a firm.

OPTIMUM CAPITAL STRUCTURE

- **In taking a financing decision, the financial manager's job is to come out with an optimum capital structure.**

- **Optimum capital structure is the level of debt equity proportion, where the market value per share is maximum and the cost of capital is minimum.**

FEATURES OF CAPITAL STRUCTURE

- **Profitability / Return**
- **Solvency / Risk**
- **Flexibility**
- **Conservation / Capacity**
- **Control**

DETERMINANTS OF CAPITAL STRUCTURE

- Tax benefit of debt
- Flexibility
- Control
- Industry Leverage Ratios
- Degree of Competition
- Industry Life Cycle
- Agency Costs
- Company Characteristics
- Timing of Public Issue

CAPITAL STRUCTURE THEORIES

4 major theories explaining the relationship between capital structure, cost of capital and valuation of the firm.

- **Net Income (NI) Approach**
- **Net Operating Income (NOI) Approach**
- **Traditional or Intermediate Approach or WACC**
- **Modigliani Miller Approach (MM)**

NET INCOME (NI) APPROACH – *David Durand*

A change in the proportion of capital structure will lead to a corresponding change in Ko and V

The theory suggests that the value of the firm increases by decreasing the overall cost of capital through higher debt proportion.

For example, if the equity-debt mix changes to 20: 80 from 50:50, it would positively impact the value of the firm and increase the value per share.

The formula to calculate the average cost of capital is as follows:

$$K_o = K_d (B / (B+S)) + K_e (S / (B+S))$$

Where,

Ko - Average cost of capital.
Kd - Cost of debt.
B - Market value of debt.
S - Market value of equity.
Ke - Cost of equity.

Assumptions

- There are no taxes
- Cost of debt is less than the cost of equity;
- Use of debt in capital structure does not change the risk perception of investors;
- Cost of debt and cost of equity remains constant.

NET OPERATING INCOME (NOI) APPROACH

This theory is given by David Durand.

Valuation of the firm is irrelevant to capital structure.

Valuation of the firm does not affected by the change in the proportion of debt .

The formula for market value of the firm:

$$V = NOI / Ko = (V = B + S)$$

Assumptions

- **There are no corporate taxes.**
- **Cost of debt remains constant at all level of debt.**
- **Overall cost of capital remains constant**

TRADITIONAL OR INTERMEDIATE APPROACH

Advocated by Ezra Solomon and Fred Weston, is a midway between the NI and NOI approach.

The crux of this approach is that, through a judicious combination of debt and equity, a firm increases its value and reduces the cost of capital.

However, beyond a critical point, the risk to the investors as well as to the creditors would increase, also the financial risk.

Assumptions

- **The rate of interest on debt remains constant for a certain period**
- **The expected rate by equity shareholders remains constant or increase gradually**
- **The WACC first decreases and then increases.**

MODIGLIANI MILLER APPROACH (MM)

MM theory relating to the relationship between cost of capital and valuation is similar to the NOI approach.

The main idea of the M&M theory is that the capital structure of a company does not affect its overall value.

According to this approach, the value of the firm is independent of its capital structure.

Assumptions of Modigliani and miller theory :

- **No taxes.**
- **Transaction cost equals to zero.**
- **Floatation cost equals to zero.**
- **Symmetrical information (same information is accessed by both investors and corporates).**
- **No corporate dividend tax.**

LEVERAGE ANALYSIS

LEVERAGE ANALYSIS

Leverage refers to the use of borrowed capital to amplify potential returns or losses on an investment, and it comes with advantages and risks.

From the financial management point of view, "the firm's ability to use fixed cost assets or sources of funds to magnify the returns to its owners".

According to James Horne, leverage is, "the employment of an asset or sources of funds for which the firm has to pay a fixed cost or fixed return."

Here fixed cost (operating cost) or fixed returns (financial cost) remains constant irrespective of the level of output.

TYPES OF LEVERAGE

- **Operating leverage**
- **Financial leverage**
- **Combined leverage**

OPERATING LEVERAGE

Operating leverage is present in any time a firm has operating costs regardless of the level of production.

The degree of operating leverage may be defined as the change in the percentage of operating income (EBIT), for the change in percentage of sales revenue.

$$\text{Degree of Operating Leverage} = \frac{\text{Percentage change in EBIT}}{\text{Percentage change in sales}}$$

Or

$$\text{DOL} = \frac{\text{Contribution}}{\text{Operating profit (EBIT)}}$$

Operating leverage may be favorable or unfavorable. High degree of operating leverage indicates high degree of risk.

FINANCIAL LEVERAGE

According to Lawrence, financial leverage is the ability of the firm to used fixed financial charges to magnify the effects of changes in EBIT on the firms earning per share.

Financial Leverage = EBIT or operating profit / EBT or taxable income

OR

Degree of financial leverage (DFL)= Percentage change in EPS / Percentage change in EBIT

A financial leverage may be positive or negative.
Favourable leverage occurs when the firm earns more on the assets purchased with the funds, than the fixed cost of their use and vice versa.

COMBINED LEVERAGE

Degree of Combined Leverage

$$= \frac{\text{Percentage change in EPS}}{\text{Percentage change in sales}}$$

Or

$$DCL = \frac{\text{Contribution}}{\text{(EBIT -T)}}$$

DIVIDEND DECISION

Introduction

- **Dividend is the portion of earnings available to equity shareholders that are equally distributed among the equity shareholders.**
- **The term ‘dividend ’refers to that portion of company’s net earnings that is paid out to the equity shareholders.**
- **The cash available for the payment of dividends is affected by the firm’s investment decision, and financing decision.**
- **Dividend decision affects the value of the firm.**

Dividend Decision

- Determination of portion of EPS to be declared as dividend per share.
- Whether to distribute all profits or a portion of Profit and retain the balance with it.
- The decision depends upon the preference of the shareholders and investment opportunities available to the firm.
- Dividend decision has a strong influence on the market price of the share.
- Dividend policy is to be determined in terms of its impact on shareholders value.

FORMS / TYPES OF DIVIDENDS

Firms may declare dividends in the form:

Cash dividend - Companies pay dividends in the form of cash.

Scrip dividend - are issued transferable promissory notes for a shorter maturity period. (promissory note).

Bond dividend - Bond dividends carry longer maturity whereas scrip dividends carry shorter maturity.

Property dividend - Payment of dividend takes place in the form of property.

Stock dividends - Stock dividend is the payment of additional shares of common stocks to the ordinary shareholders.

Bonus dividends - Bonus shares are shares issued to the existing shareholders as a result of capitalization of resources.

FACTORS INFLUENCING THE DIVIDEND POLICY OF THE FIRM

- Nature of Business.
- Age of Company.
- Liquidity Position of Company.
- Legal Rules.
- Net Profits.
- Insolvency Rule.
- Contractual Requirements.
- Financial Needs of the Company.
- Access to the Capital Market (External Sources).
- Equity Shareholders Preference for Current Income.
- Requirements of Institutional Investor

- **Control Objective**
- **Inflation**
- **Dividend Policy of Competitors**
- **Past Dividend Rates of the Company**

Others

Apart from the above discussed, there are some other factors, which influence the dividend policy of a firm, such as Trade Cycles, Corporate taxation policy, attitude of investors group and repayment of loan.

THEORIES OF DIVIDEND

According to one school of thought, dividends are relevant to the valuation of the firm.

RELEVANT THEORY

If the choice of the dividend policy affects the value of a firm.

Walter's Model

Prof. James E Walter argues that the choice of dividend payout ratio almost always affects the value of the firm

Gordon's model

Another theory, which contents that dividends are relevant, is the Gordon's model. This model opines that dividend policy of a firm affects its value

IRRELEVANCE THEORY

Modigliani & Miller

According to MM, the dividend policy of a firm is irrelevant, as it does not affects the wealth of shareholders.

MERGERS & ACQUISITIONS

When two or more companies agree to combine their operations, where one company survives and the other loses its corporate existence, a merger is affected. The surviving company acquires all the assets and liabilities of the merged company.

TYPES OF MERGERS

Horizontal Mergers

This type of merger involves two firms that operate and compete in a similar kind of business.

The merger is based on the assumption that it will provide economies of scale from the larger combined unit. Example: Glaxo Wellcome PLC and SmithKline Beecham PLC. Megamerger

Vertical Mergers

Vertical mergers take place between firms in different stages of production/operation, either as forward or backward integration. Unlike horizontal mergers, which have no specific timing, vertical mergers take place when both firms plan to integrate the production process and capitalise on the demand for the product.

Conglomerate Mergers

Conglomerate mergers are affected among firms that are in different or unrelated business activity. Firms that plan to increase their product lines carry out these types of mergers.

Conglomerate mergers have been sub-divided into:

Financial conglomerates

These conglomerates provide a flow of funds to every segment of their operations, exercise control and are the ultimate financial risk takers.

Managerial conglomerates

Managerial conglomerates provide managerial counsel and interaction on decisions thereby, increasing potential for improving performance.

Concentric companies

The primary difference between managerial conglomerate and concentric company is its distinction between respective general and specific management functions.

ACQUISITIONS

The term acquisition means an attempt by one firm, called the acquiring firm, to gain a majority interest in another firm, called target firm.

Friendly Takeover

The acquiring firm makes a financial proposal to target firm's management and board. This proposal might involve the merger of the two firms, the consolidation of two firms, or the creation of parent / subsidiary relationship.

Hostile Takeover

A hostile takeover may not follow a preliminary attempt at a friendly takeover. For example, it is not uncommon for an acquiring firm to embrace the target firm's management is called as a bear hug.

THANK YOU