

SUBJECTNAME:FINANCIAL MANAGEMENT
CLASS:-III B.Com(CA)
UNIT-II

Goals of Finance Function – Financing Decisions – Financial Planning – Financial Forecasting – Capital Structure Decisions – Net Income Approach, NOI Approach and MM Approach-Capitalization – Cost of Capital – Computation of Cost of Capital-Dividend Policy-Factors Determining Dividend Policy.

Finance Function:

The objective of finance function is to arrange as much funds for the business as are required from time to time. This function has the following objectives.

1. Assessing the Financial Requirements

The main objective of finance function is to assess the financial needs of an organization and then finding out suitable sources for raising them. The sources should be commensurate with the needs of the business. If funds are needed for longer periods then long-term sources like share capital, debentures, term loans may explored.

2. Proper Utilization of Funds

Though raising of funds is important but their effective utilization is more important. The funds should be used in such a way that maximum benefit is derived from them. The returns from their use should be more than their cost. It should be ensured that funds do not remain idle at any point of time. The funds committed to various operations should be effectively utilized. Those projects should be preferred which are beneficial to the business.

3. Increasing Profitability

The planning and control of finance function aims at increasing profitability of the concern. It is true that money generates money. To increase profitability, sufficient funds will have to be invested. Finance function should be so planned

that the concern neither suffers from inadequacy of funds nor wastes more funds than required. A proper

control should also be exercised so that scarce resources are not frittered away on uneconomical operations. The cost of acquiring funds also influences profitability of the business.

4. Maximizing Value of Firm

Finance function also aims at maximizing the value of the firm. It is generally said that a concern's value is linked with its profitability.

Types of Financial Decisions in Financial Management

Everything you need to know about the types of financial decisions taken by a company. The key aspects of financial decision-making relate to financing, investment, dividends and working capital management.

Decision making helps to utilise the available resources for achieving the objectives of the organization, unless minimum financial performance levels are achieved, it is impossible for a business enterprise to survive over time.

Therefore financial management basically provides a conceptual and analytical framework for financial decision making.

The types of financial decisions can be classified under:-

1. Long-Term Finance Decisions
2. Short-Term Finance Decisions.

There are four main financial decisions:-

1. Capital Budgeting or Long term Investment Decision
2. Capital Structure or Financing Decision
3. Dividend Decision
4. Working Capital Management Decision.

Types of Financial Decisions: Investment Decision, Financing Decision, Dividend Decision and Working Capital Management Decision

Types of Financial Decisions – That Every Company is Required to Take: Investment Decision, Financing Decision and Dividend Decision

Every company is required to take three main financial decisions, they are:

1. Investment Decision
2. Financing Decision
3. Dividend Decision

1. Investment Decision:

A financial decision which is concerned with how the firm's funds are invested in different assets is known as investment decision. Investment decision can be long-term or short-term.

A long term investment decision is called capital budgeting decisions which involve huge amounts of long term investments and are irreversible except at a huge cost. Short-term investment decisions are called working capital decisions, which affect day to day working of a business. It includes the decisions about the levels of cash, inventory and receivables

A bad capital budgeting decision normally has the capacity to severely damage the financial fortune of a business.

A bad working capital decision affects the liquidity and profitability of a business.

Factors Affecting Investment Decisions / Capital Budgeting Decisions:

1. Cash flows of the project- The series of cash receipts and payments over the life of an investment proposal should be considered and analyzed for selecting the best proposal.
2. Rate of return- The expected returns from each proposal and risk involved in them should be taken into account to select the best proposal.
3. Investment criteria involved- The various investment proposals are evaluated on the basis of capital budgeting techniques. Which involve calculation regarding investment amount, interest rate, cash flows, rate of return etc. It is to be considered which technique to use for evaluation of projects.

2. Financing Decision:

A financial decision which is concerned with the amount of finance to be raised from various long term sources of funds like, equity shares, preference shares, debentures, bank loans etc. Is called financing decision. In other words, it is a decision on the 'capital structure' of the company.

Capital Structure Owner's Fund + Borrowed Fund

Financial Risk:

The risk of default on payment of periodical interest and repayment of capital on 'borrowed funds' is called financial risk.

Factors Affecting Financing Decision:

1. Cost- The cost of raising funds from different sources is different. The cost of equity is more than the cost of debts. The cheapest source should be selected prudently.
2. Risk- The risk associated with different sources is different. More risk is associated with borrowed funds as compared to owner's fund as interest is paid on it and it is also repaid after a fixed period of time or on expiry of its tenure.
3. Flotation cost- The cost involved in issuing securities such as broker's commission, underwriter's fees, expenses on prospectus etc. Is called flotation cost. Higher the flotation cost, less attractive is the source of finance.
4. Cash flow position of the business- In case the cash flow position of a company is good enough then it can easily use borrowed funds.
5. Control considerations- In case the existing shareholders want to retain the complete control of business then finance can be raised through borrowed funds but when they are ready for dilution of control over business, equity shares can be used for raising finance.
6. State of capital markets- During boom period, finance can easily be raised by issuing shares but during depression period, raising finance by means of debt is easy.

3. Dividend Decision:

A financial decision which is concerned with deciding how much of the profit earned by the company should be distributed among shareholders (dividend) and how much should be retained for the future contingencies (retained earnings) is called dividend decision.

Dividend refers to that part of the profit which is distributed to shareholders. The decision regarding dividend should be taken keeping in view the overall objective of maximizing shareholder's wealth.

Factors affecting Dividend Decision:

1. Earnings- Company having high and stable earning could declare high rate of dividends as dividends are paid out of current and past earnings.

2. Stability of dividends- Companies generally follow the policy of stable dividend. The dividend per share is not altered in case earning changes by small proportion or increase in earnings is temporary in nature.
3. Growth prospects- In case there are growth prospects for the company in the near future then, it will retain its earnings and thus, no or less dividend will be declared.
4. Cash flow positions- Dividends involve an outflow of cash and thus, availability of adequate cash is foremost requirement for declaration of dividends.
5. Preference of shareholders- While deciding about dividend the preference of shareholders is also taken into account. In case shareholders desire for dividend then company may go for declaring the same. In such case the amount of dividend depends upon the degree of expectations of shareholders.
6. Taxation policy- A company is required to pay tax on dividend declared by it. If tax on dividend is higher, company will prefer to pay less by way of dividends whereas if tax rates are lower, then more dividends can be declared by the company.

Type # 1. Investment Decision:

It is more important than the other two decisions. It begins with a determination of the total amount of assets needed to be held by the firm. In other words, investment decision relates to the selection of assets, on which a firm will invest funds.

The required assets fall into two groups:

(i) Long-term Assets (fixed assets – plant & machinery land & buildings, etc.,) which involve huge investment and yield a return over a period of time in future. Investment in long-term assets is popularly known as “capital budgeting”. It may be defined as the firm’s decision to invest its current funds most efficiently in fixed assets with an expected flow of benefits over a series of years.

(ii) Short-term Assets (current assets – raw materials, work-in-process, finished goods, debtors, cash, etc.,) that can be converted into cash within a financial year without diminution in value. Investment in current assets is popularly termed as “working capital management”. It relates to the management of current assets.

It is an important decision of a firm, as short-survival is the prerequisite for long-term success. Firm should not maintain more or less assets. More assets reduces return and there will be no risk, but having less assets is more risky and more profitable. Hence, the main aspects of working capital management are the trade-off between risk and return.

Management of working capital involves two aspects. One determination of the amount required for running of business and second financing these assets.

Type # 2. Financing Decision:

After estimation of the amount required and the selection of assets required to be purchased, the next financing decision comes into the picture. Financial manager is concerned with makeup of the right hand side of the balance sheet. 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.

It should be on optimum finance mix, which maximizes shareholders' wealth. A proper balance will have to be struck between risk and return. Debt involves fixed cost (interest), which may help in increasing the return on equity but also increases risk. Raising of funds by issue of equity shares is one permanent source, but the shareholders will expect higher rates of earnings.

The two aspects of capital structure are- One capital structure theories and two determination of optimum capital structure.

Type # 3. Dividend Decision:

This is the third financial decision, which relates to dividend policy. Dividend is a part of profits, which are available for distribution to equity shareholders. Payment of dividends should be analysed in relation to the financial decision of a firm. There are two options available in dealing with net profits of a firm, viz., distribution of profits as dividends to the ordinary shareholders where there is no need of retention of earnings or they can be retained in the firm itself if they are required for financing of any business activity.

But distribution of dividends or retaining should be determined in terms of its impact on the shareholders' wealth. Financial manager should determine the optimum dividend policy, which maximises market value of the share thereby market value of the firm. Considering the factors to be considered while determining dividends is another aspect of dividend policy.

What Is Financial Planning?

Financial planning is the practice of putting together a plan for your future, specifically around how you will manage your finances and prepare for all of the potential costs and issues that may arise. The process involves evaluating your current financial situation, identifying your goals and then developing and implementing relevant recommendations.

Financial planning is holistic and broad, and it can encompass a variety of services, which we detail below. Rather than focusing on a single aspect of your finances, it views clients as real people with a variety of goals and responsibilities. It then addresses a number of financial realities to figure out how to best enable people to make the most of their lives.

Here are eight common services that are generally offered as part of financial planning:

- **Tax planning:** Financial planners often help clients address certain tax issues. They can also figure out how to maximize your tax refunds and minimize your tax liability. Certain advisors may also be able to actually help you with preparing your taxes and filing your annual taxes.
- **Estate planning:** Estate planning seeks to make things a bit easier for your loved ones after you die. Preparing a will may be part of a financial planner's services. Estate planning also helps prepare for any estate tax you may be subject to.
- **Retirement planning:** You presumably want to stop working some day. Retirement planning services help you prepare for that day. They ensure that you've saved enough money to live the lifestyle you want in retirement.
- **Philanthropic planning:** It's always nice to give something to people who need it or help a cause close to your heart. Financial planning can help you ensure you're doing it efficiently and getting all the tax benefits you're eligible for.
- **Education funding planning:** If you have children or other dependents who wish to pursue a college degree, you may want to help them to pay for it. Financial planning can help make sure you are able to do so.
- **Investment planning:** Though financial planning doesn't include the actual management of your assets, it can still help with your investment portfolio

by mapping out how much you should be investing and in which types of investments.

- **Insurance planning:** A financial planner can help you evaluate your insurance needs. Some financial planners are also licensed insurance agents and can sell you insurance themselves. However, they'll likely earn a commission, which would create a conflict of interest.
- **Budgeting:** This is perhaps the cornerstone of financial planning. A planner can make sure you are spending the right amount given your income and can also make sure that you aren't going into debt.

The exact services offered by a financial planner will vary based on the individual. Make sure the financial planner you choose offers the services you need.

WHAT IS FINANCIAL FORECASTING?

Financial forecasting is predicting a company's financial future by examining historical performance data, such as revenue, cash flow, expenses, or sales. This involves guesswork and assumptions, as many unforeseen factors can influence business performance.

Financial forecasting is important because it informs business decision-making regarding hiring, budgeting, predicting revenue, and strategic planning. It also helps you maintain a forward-focused mindset.

Each financial forecast plays a major role in determining how much attention is given to individual expense items. For example, if you forecast high-level trends for general planning purposes, you can rely more on broad assumptions than specific details. However, if your forecast is concerned with a business's future, such as a pending merger or acquisition, it's important to be thorough and detailed.

7 FINANCIAL FORECASTING METHODS

Pro forma statements are incredibly valuable when forecasting revenue, expenses, and sales. These findings are often further supported by one of seven financial forecasting methods that determine future income and growth rates.

There are two primary categories of forecasting: quantitative and qualitative.

Quantitative Methods

When producing accurate forecasts, business leaders typically turn to quantitative forecasts, or assumptions about the future based on historical data.

Qualitative Methods

When it comes to forecasting, numbers don't always tell the whole story. There are additional factors that influence performance and can't be quantified. Qualitative forecasting relies on experts' knowledge and experience to predict performance rather than historical numerical data.

These forecasting methods are often called into question, as they're more subjective than quantitative methods. Yet, they can provide valuable insight into forecasts and account for factors that can't be predicted using historical data.

6. Delphi Method

The Delphi method of forecasting involves consulting experts who analyze market conditions to predict a company's performance.

A facilitator reaches out to those experts with questionnaires, requesting forecasts of business performance based on their experience and knowledge. The facilitator then compiles their analyses and sends them to other experts for comments. The goal is to continue circulating them until a consensus is reached.

7. Market Research

Market research is essential for organizational planning. It helps business leaders obtain a holistic market view based on competition, fluctuating conditions, and consumer patterns. It's also critical for startups when historical data isn't available. New businesses can benefit from financial forecasting because it's essential for recruiting investors and budgeting during the first few months of operation.

When conducting market research, begin with a hypothesis and determine what methods are needed. Sending out consumer surveys is an excellent way to better understand consumer behavior when you don't have numerical data to inform decisions.

1. Percent of Sales

Internal pro forma statements are often created using percent of sales forecasting. This method calculates future metrics of financial line items as a percentage of sales. For example, the cost of goods sold is likely to increase proportionally with sales; therefore, it's logical to apply the same growth rate estimate to each.

To forecast the percent of sales, examine the percentage of each account's historical profits related to sales. To calculate this, divide each account by its sales, assuming the numbers will remain steady. For example, if the cost of goods sold has historically been 30 percent of sales, assume that trend will continue.

2. Straight Line

The straight-line method assumes a company's historical growth rate will remain constant. Forecasting future revenue involves multiplying a company's previous year's revenue by its growth rate. For example, if the previous year's growth rate was 12 percent, straight-line forecasting assumes it'll continue to grow by 12 percent next year.

Although straight-line forecasting is an excellent starting point, it doesn't account for market fluctuations or supply chain issues.

3. Moving Average

Moving average involves taking the average—or weighted average—of previous periods to forecast the future. This method involves more closely examining a business's high or low demands, so it's often beneficial for short-term forecasting. For example, you can use it to forecast next month's sales by averaging the previous quarter.

Moving average forecasting can help estimate several metrics. While it's most commonly applied to future stock prices, it's also used to estimate future revenue.

To calculate a moving average, use the following formula:

$$A1 + A2 + A3 \dots / N$$

Formula breakdown:

A = Average for a period

N = Total number of periods

Using weighted averages to emphasize recent periods can increase the accuracy of moving average forecasts.

4. Simple Linear Regression

Simple linear regression forecasts metrics based on a relationship between two variables: dependent and independent. The dependent variable represents the forecasted amount, while the independent variable is the factor that influences the dependent variable.

The equation for simple linear regression is:

$$Y = BX + A$$

Formula breakdown:

Y = Dependent variable (the forecasted number)

B = Regression line's slope

X = Independent variable

A = Y-intercept

5. Multiple Linear Regression

If two or more variables directly impact a company's performance, business leaders might turn to multiple linear regression. This allows for a more accurate forecast, as it accounts for several variables that ultimately influence performance.

To forecast using multiple linear regression, a linear relationship must exist between the dependent and independent variables. Additionally, the independent variables can't be so closely correlated that it's impossible to tell which impacts the dependent variable.

Capital Structure Theory – Net Income Approach

The Net Income Approach suggests that the value of the firm can be increased by decreasing the overall cost of capital (WACC) through a higher debt proportion. There are various theories that propagate the 'ideal' capital mix/capital structure for a firm. Capital structure is the proportion of debt and equity in which a corporate finances its business. The capital structure of a company/firm plays a very important role in determining the value of a firm.

A corporate can finance its business mainly by 2 means, i.e., debts and equity. However, the proportion of each of these could vary from business to business. A company can choose to have a structure with 50% each of debt and equity or more of one and less of another. Capital structure is also referred to as financial leverage, which strictly means the proportion of debt or borrowed funds in the financing mix of a company

Debt structuring can be a handy option because the interest payable on debts is tax-deductible (deductible from net profit before tax). Hence, debt is a cheaper source of finance. But increasing debt has its share of drawbacks like increased risk of bankruptcy, increased fixed interest obligations, etc.

For finding the optimum capital structure to maximize shareholders' wealth or the value of the firm, different capital structure theories (approaches) have evolved.

Capital Structure Theory



Net Income Approach



Read [Capital Structure & its Theories](#) to know more about what is capital structure and what are its different theories. Let us now look at the first approach.

Net Income Approach Explained

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

WACC	=	Required Rate of Return x Amount of Equity + Cost of debt x Amount of Debt
		Total Amount of Capital (Debt + Equity)

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

For example, vis-à-vis the equity-debt mix of 50:50, if the equity-debt mix changes to 20: 80, it would positively impact the value of the business and increase the

value

per

share.

NET INCOME APPROACH

Net Income Approach was presented by Durand which suggests that value of the firm can be increased by decreasing the overall cost of capital (WACC) through higher debt proportion.

- ASSUMPTION**
- Confidence level of the investors will not be affected by increase in debt
 - No sources of finance like Preference Share Capital and Retained Earning.
 - Uniform dividend pay out ratio; it is 1.
 - Floatation Cost = 0, Transaction Cost = 0 and CDT = 0%
 - Perfect Capital market and Infinite sources of finance

CALC. PROCEDURE

#	Particulars	Amount
A	EBIT	XXX
B	Less : Interest Cost (Debt X Interest Rate)	(XX)
C	EAT (Tax is assumed to be absent)	XXX
D	Shareholders Earnings (C=D)	XXX
E	Market Value of Equity Shares (D/Cost of Equity)	XX
F	Market Value of Debt	XX
G	Total Market Value of Firm (E + F)	XXX
H	Overall Cost of Capital in percentage (A/G*100)	XX%

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Assumptions of Net Income Approach

The 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 Earnings.
- All companies have a uniform dividend payout ratio; it is 1.
- There is no floatation cost, no transaction cost, and corporate dividend tax.
- The capital market is perfect; it means information about all companies is available to all investors, and there are no chances of overpricing or

underpricing of security. Further, it means that all investors are rational. So, all investors want to maximize their return by minimizing risk.

- All sources of finance are for infinity. There are no redeemable sources of finance.

Example

Consider a fictitious company with the below figures—all figures in USD.

Earnings before Interest Tax (EBIT)	=	100,000
Bonds (Debt part)	=	300,000
Cost of Bonds issued (Debt)	=	10%
Cost of Equity	=	14%

Calculating the value of a company

EBIT	=	100,000
Less: Interest cost (10% of 300,000)	=	30,000
Earnings (since tax is assumed to be absent)	=	70,000
Shareholders' Earnings	=	70,000
Market value of Equity (70,000/14%)	=	500,000

Market value of Debt	=	300,000
Total Market value	=	800,000
Overall cost of capital	=	EBIT/(Total value of the firm)
=		100,000/800,000
=		12.5%

Now, assume that the proportion of debt increases from 300,000 to 400,000, and everything else remains the same.

(EBIT)	=	100,000
Less: Interest cost (10% of 400,000)	=	40,000
Earnings (since tax is assumed to be absent)	=	60,000
Shareholders' Earnings	=	60,000

Market value of Equity (60,000/14%)	=	428,570 (approx)
Market value of Debt	=	400,000
Total Market value	=	828,570
Overall cost of capital	=	EBIT/(Total value of the firm)
=		100,000/828,570
=		12% (approx)

WHAT IS COST OF CAPITAL?

Cost of capital is the minimum rate of return or profit a company must earn before generating value. It's calculated by a business's accounting department to determine financial risk and whether an investment is justified.

Company leaders use cost of capital to gauge how much money new endeavors need to generate to offset upfront costs and achieve profit. They also use it to analyze the potential risk of future business decisions.

Cost of capital is extremely important to investors and analysts. These groups use it to determine stock prices and potential returns from acquired shares. For example, if a company's financial statements or cost of capital are volatile, cost of shares may plummet; as a result, investors may not provide financial backing.

HOW TO CALCULATE COST OF CAPITAL

To determine cost of capital, business leaders, accounting departments, and investors must consider three factors: cost of debt, cost of equity, and weighted average cost of capital (WACC).

1. Cost of Debt

While debt can be detrimental to a business's success, it's essential to its capital structure. Cost of debt refers to the pre-tax interest rate a company pays on its debts, such as loans, credit cards, or invoice financing. When this kind of debt is kept at a manageable level, a company can retain more of its profits through additional tax savings.

Companies typically calculate cost of debt to better understand cost of capital. This information is crucial in helping investors determine if a business is too risky. Cost of debt also helps identify the overall rate being paid to use funds acquired from financial strategies, such as debt financing, which is selling a company's debt to individuals or institutions who, in turn, become creditors of that debt.

There are many ways to calculate cost of debt. One common method is adding your company's total interest expense for each debt for the year, then dividing it by the total amount of debt.

Another formula that businesses and investors can use to calculate cost of debt is:

$$\text{Cost of Debt} = (\text{Risk-Free Rate of Return} + \text{Credit Spread}) \times (1 - \text{Tax Rate})$$

Here's a breakdown of this formula's components:

- Risk-free return: Determined from the return on US government security
- Credit spread: Difference in yield between US Treasury bonds and other debt securities
- Tax rate: Percentage at which a corporation is taxed

Companies in the early stages of operation may not be able to leverage debt in the same way that well-established corporations can. Limited operating histories and assets often force smaller companies to take a different approach, such as equity financing, which is the process of raising capital through selling company shares.

2. Cost of Equity

Equity is the amount of cash available to shareholders as a result of asset liquidation and paying off outstanding debts, and it's crucial to a company's long-term success.

Cost of equity is the rate of return a company must pay out to equity investors. It represents the compensation that the market demands in exchange for owning an asset and bearing the risk associated with owning it.

This number helps financial leaders assess how attractive investments are—both internally and externally. It's difficult to pinpoint cost of equity, however, because it's determined by stakeholders and based on a company's estimates, historical information, cash flow, and comparisons to similar firms.

Cost of equity is calculated using the Capital Asset Pricing Model (CAPM), which considers an investment's riskiness relative to the current market.

Cost of Equity = Risk-Free Rate of Return + Beta × (Market Rate of Return - Risk-Free Rate of Return)

Here's a breakdown of this formula's components:

- Risk-free return: Determined from the return on US government security
- Average rate of return: Estimated by stocks, such as Dow Jones

- Return risk: Stock's beta, which is calculated and published by investment services for publicly held companies

Companies that offer dividends calculate the cost of equity using the Dividend Capitalization Model. To determine cost of equity using the Dividend Capitalization Model, use the following formula:

$$\text{Cost of Equity} = (\text{Dividends per Share} / \text{Current Market Value of Stocks}) + (\text{Dividend Growth Rate})$$

Here's a breakdown of this formula's components:

- Dividends: Amount of money a company pays regularly to its shareholders
- Market value stocks: Fractional ownership of equity in an organization that's value is determined by financial markets
- Dividend growth rate: Annual percentage rate of growth of a dividend over a period

3. Weighted Average Cost of Capital (WACC)

The weighted average cost of capital (WACC) is the most common method for calculating cost of capital. It equally averages a company's debt and equity from all sources.

Companies use this method to determine rate of return, which indicates the return that shareholders demand to provide capital. It also helps investors gauge the risk of cash flows and desirability for company shares, projects, and potential acquisitions. In addition, it establishes the discount rate for future cash flows to obtain value for a business.

WACC is calculated by multiplying the cost of each capital source (both equity and debt) by its relevant weight by market value, then adding the products together to determine the total. The formula is:

$$\text{WACC} = (E/V \times R_e) + ((D/V \times R_d) \times (1 - T))$$

Here's a breakdown of this formula's components:

- E: Market value of firm's equity
- D: Market value of firm's debt
- V: Total value of capital (equity + debt)
- E/V: Percentage of capital that's equity
- D/V: Percentage of capital that's debt
- Re: Required rate of return
- Rd: Cost of debt
- T: Tax rate

Factors Affecting Dividend Policy

Dividend is the amount paid out to the shareholders out of the earnings for equity shareholders. That part of the total earnings, which is not paid out as dividend, is the retained earnings (RE), which is ploughed back or reinvested in the business. The higher the **amount of dividend**, the lower the retained earnings and vice versa. Retained profit increases the long-term capital base of the company and thus increases the potential of future earning capacity. On the other hand, the higher the dividend, the higher the earnings of the equity shareholders at present. The question is what is the trade-off between present earnings and higher future earnings; what is the **optimum dividend policy**. As in other matters, that **dividend policy is optimum**, which maximizes the net wealth of equity shareholders. The issue before **dividend policy** is to determine the best distribution of profit between dividend per share (DPS) and retained earnings per share (RES).

There are some aspects which may affect dividend policy of a firm. They are:

1. Stability

In addition to the percentage of dividend payout of a company over the long run, investors may value stable dividends over this period. Other things being equal, the market price of the shares of a company may be higher if it pays a stable dividend than if it pays a fixed percentage of its earnings, which may fluctuate. A stable policy implies not only maintaining a percentage of dividend payout in relation to earnings over the long run, but also the manner in which the actual dividend are

paid. Rather than varying the dividends directly with changes in Earnings Per Share (EPS) every year, dividend can be maintained

2. Liquidity

The liquidity of a company is an important consideration in many dividend decisions. A company that is growing and profitable may not be liquid, because its funds may be locked up in fixed assets or permanent working capital. As the company may like to maintain some liquidity cushion to give it flexibility and protection against uncertainty, it may be reluctant to jeopardize this position in order to pay a large dividend. However, if a firm has the ability to borrow at short notice, it may be flexible in its dividend policy.

3. Control

If a company pays substantial dividends, it may have to raise capital at a later time to finance profitable investment opportunities. Such a course may sometimes lead to a dilution of management control, and for this reason, the present management may like to use retained earnings as the principal source of finance. However, this policy may act as a double-edged sword, and may actually harm the interest of the owner group. A low dividend payout may motivate the small individual shareholders to sell their shares to a take over tycoon, who may seize control by acquiring majority shares from the market.

4. Shareholding Pattern

In many of the closely held companies, the promoter group keeps a close watch on the pulse of the different shareholding groups and their preferences for dividends and/or capital gains. The dividend policy is formulated based on a consensus.

5. Timing of Investment Opportunities

A company may formulate long-term plans, and identify profitable investment opportunities. But if the proposed investment calls for funds after time lag of say,

more than five years, it would be worthwhile to opt for a higher dividend payout immediately and go in for fresh equity or rights issue when the need for funds arises.

6. Legal Constraints

Sometimes term loan agreements – especially those under the soft loan scheme for modernization or as part of a package of revival of sick undertakings, stipulate that dividends should not be declared above a specified percentage for the stipulated period. Such a stipulation, in fact, helps the management in convincing shareholders about a lower payout ratio