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Financial Management

Question 4:

Explain the factors affecting the dividend decision.

ANSWER:

Dividend decision of a company deals with what portion of the profits is to be distributed as dividends between the shareholders and what portion is to be kept as retained earnings. The following are the factors that affect the dividend decision.

i) ***Amount of Earning***: A firm pays dividends out of its current and the past earnings. This implies that earnings play a key role in the dividend decision. A company having higher earnings will be in a position to pay a higher amount of dividend to its shareholders. In contrast to this, a company having low or limited earnings would distribute low dividends.

ii) ***Stable Earnings***: When a company has a stable and a smooth earning, they are in a position to distribute higher dividend as compared to the companies who have an unstable earning. In other words, a company having consistent and stable earnings can distribute higher amount of dividends.

iii) ***Stable Dividends***: Companies generally follow the practice of stabilising their dividends. They try to avoid frequent fluctuations in dividend per share and opt for increasing (or decreasing) the value only when there is a consistent rise (or fall) in the earnings of the company.

iv) ***Growth Prospects***: Companies aiming for a higher growth level or expansion of operations retain a higher portion of the earnings with itself for re-investment. Thus, dividend of such a company is smaller as compared to the companies with lower growth opportunities.

v) ***Cash Flow Position***: Dividend payments require cash outflow. If a company is low on cash then the dividend will be lower as compared to the company which has more liquidity. Even if a company has higher profits, it will not be able to distribute high dividends if it does not have enough cash.

vi) ***Preference of the Shareholders***: A company must keep in mind the preferences of the share holders while distributing the dividends. For instance, if the share holders prefer at least a certain amount of dividend, then the company is likely to declare the same.

vii) ***Taxation Policy***: Taxation policy plays an important role in deciding the dividends. If the taxation policy is such that a high rate of tax is levied on dividend distribution, then the companies are likely to distribute lower dividends. On the other, it might prefer to distribute higher dividends if the tax rate is low.

viii) ***Stock Market Reactions***: The amount of dividend that a company distributes affects its stock market prices. An increase in dividend by a company is viewed as a good sign by the investors and the stock price of the company goes up. On the other hand, a fall in the dividends adversely affects the stock prices. Thus, while taking the dividend decision, a company must consider the probable stock market reactions.

ix) ***Contractual Constraints***: Sometimes, while giving out loans to a company, the lender may impose some restrictions in the form of agreement. These restrictions may be related to the dividend paid in the future. In such cases, the company has to keep such agreements in mind when distributing the dividends.

x) ***Access to Capital Market***: The companies that have a greater access to the capital market tend to pay higher dividends. This is because they can rely less on retained earnings and more on other sources due to the market access. The smaller companies who have lower access to capital markets tend to pay lower dividends.

xi) ***Legal Constraints***: Companies have to adhere to the rules and policies laid out by the Companies Act. Thus, any company needs to take care of such restrictions and policies before declaring the dividends.

Question 5:

Explain the term "Trading on Equity". Why, when and how it can be used by a company?

ANSWER:

Trading on equity refers to a practice of raising the proportion of debt in the capital structure such that the earnings per share increases. A company resorts to Trading on Equity when the rate of return on investment is greater than the rate of interest on the borrowed fund. That is, the company resorts to Trading on Equity in situation of favourable financial leverage. As the difference between the return on investment and the rate of interest on debt increases, the earnings per share increase.

The use of Trading on Equity is explained in detail with the help of the following example.

Suppose there are two situations for a company. In situation I it raises a fund of Rs 5,00,000 through equity capital and in situation II, it raises the same amount through two sources- Rs 2,00,000 through equity capital and the remaining Rs3,00,000 through borrowings.

Also suppose the tax rate is 30% and the interest on borrowings is 10%. The earnings per share (EPS) in the two situations is calculated as follows.

	Situation I	**Situation II**
Earnings before interest and tax (EBIT)	1,00,000	1,00,000
Interest		30,000
Earnings Before Tax (EBT)	1,00,000	70,000
Tax	30,000	21,000
Earnings After Tax (EAT)	70,000	79,000
No. Of equity shares	50,000	20,000
$EPS = \frac{EAT}{\text{Number of equity shares}}$	$\frac{70,000}{50,000} = 1.4$	$\frac{79,000}{20,000} = 3.95$

Clearly, in the second situation the EPS is greater than in the first situation. In the second situation the company takes advantage of the Trading on Equity and raises the EPS. Here, the return on investment calculated as $\left(\frac{\text{Earnings Before Tax (EBT)}}{\text{Total Investment}} = \frac{1,00,000}{5,00,000}\right)$ is 20% while the interest on the borrowings is 10%. Thus, the Trading on Equity is profitable.

However, it should be noted that Trading on Equity is profitable and should be used only when the return on investment is greater than the interest on borrowed funds. In case the return on investment is less than the rate of interest to be paid, the Trading on Equity should be avoided.

Suppose instead of Rs 1,00,000 the company earns just Rs 25,000. In such a case the EPS are calculated as follows.

	Situation I	**Situation II**
Earnings before interest and tax (EBIT)	40,000	40,000
Interest		10,000
Earnings Before Tax (EBT)	25,000	10,000

Tax	30,000	3,000
Earnings After Tax (EAT)	70,000	7,000
No. Of equity shares	50,000	20,000
$\text{EPS}=\frac{\text{EAT}}{\text{Number of equity shares}}$	$\frac{70,000}{50,000}=1.4$	$\frac{7,000}{20,000}=0.35$

Clearly in this case, the EPS in Situation II falls. Here the return on investment is only 8% $\left(\frac{\text{Earnings Before Tax (EBT)}}{\text{Total Investment}}=\frac{40,000}{5,00,000}\right)$ while the interest on the borrowings is 10%. Thus, in this situation the Trading on Equity is not favourable and should be discouraged.

Hence, it can be said that a firm can use Trading on Equity if it is earning high profits and can increase the EPS by raising more funds through borrowings.

Question 1:

'S' Limited is manufacturing steel at its plant in India. It is enjoying a buoyant demand for its products as economic growth is about 7%-8% and the demand for steel is growing. It is planning to set up a new steel plant to cash on the increased demand. It is estimated that it will require about Rs 5000 crores to set up and about Rs 500 crores of working capital to start the new plant.

Questions

1. Describe the role and objectives of financial management for this company.
2. Explain the importance of having a financial plan for this company. Give an imaginary plan to support your answer.
3. What are the factors which will affect the capital structure of this company?
4. Keeping in mind that it is a highly capital-intensive sector, what factors will affect the fixed and working capital. Give reasons in support of your answer.

ANSWER:

1. The role of financial management in this company is to ascertain:

i. ***The amount and structure of fixed assets***: A decision to invest more in a particular type of fixed asset would increase its share in the overall composition of fixed assets.

For instance, a financial management decision to invest more in fixed assets would directly increase the size of the fixed assets held by the business.

ii. ***The composition of funds used***: The composition of funds used by a company refers to the short-term and long-term financing sources used by that company. It is determined by the company's decisions regarding liquidity and profitability. For instance, a company aiming at higher liquidity would rely more on long-term financing and vice versa.

iii. ***The proportion of debt, equity, etc. in long-term financing***: What proportion of the long-term finance is to be raised by the way of debt or equity is a financial decision, which in itself is a part of financial management.

iv. ***The quantum and composition of current assets***: The amount of current assets (i.e. working capital) that the organisation holds depends on the financial decisions pertaining to the amount of fixed assets to be held. A decision to increase the quantum of fixed assets directly increases the working capital requirements of the business and vice versa.

The basic objective of the financial management in this company would be to ***maximise the shareholders' wealth***. The company must opt for those financial decisions that prove gainful from the point of view of the shareholders (i.e. increase in the market value of the shares). The market value of shares increase when the benefits from a financial decision exceed the cost involved in taking them.

2. The following points highlight the importance of financial planning for the company.

i. Financial plan would enable the company to forecast the future in a better manner. For instance, it would be able to forecast the sales return that it would be able to earn through the expansion.
ii. Proper planning would help to avoid any shortage or surplus of funds, thereby ensuring optimum utilisation of funds.
iii. Planning would help in better coordination of the production and sales activities.
iv. Financial planning would help in avoiding wastages of time, effort and money.
v. With a clear definition of targets and policies, financial planning helps in evaluating current performance in a better way.

Financial Plan

It is given that the company requires Rs 5000 crore fixed capital and Rs 500 crore working capital. Of this the company can collect 50 % through issue of shares and the remaining 50% can be collected through borrowed funds.

3. The following are the factors affecting the choice of capital structure.

i. ***Cash flow***: The company should opt for debt capital only in case of strong cash flow position. This is because debt cash is required to pay the principle as well as the interest on the debt.

ii. ***Debt-service coverage ratio (DSCR)***: This ratio shows the cash payment obligations of a company as against the availability of cash. In case of high DSCR, the company can opt for debt.

iii. ***Equity cost***: Cost of equity is directly related to the financial risk faced by the company. With higher financial risk, shareholders expectations of return increases. This in turn implies that the cost of equity rises. With high cost of equity it becomes difficult for the company to opt for equity.

iv. ***Condition of stock market***: It is easy to opt for equity capital in case of good stock market conditions. On the other hand, in case of poor stock market conditions it becomes difficult to opt for equity capital.

v. ***Interest coverage Ratio***: This ratio refers to the number of times ‘earnings before interest and tax’ is able to meet the interest rate obligations. Higher interest coverage ratio implies lower risk for the company, thereby the company can opt for higher portion of debt in the capital structure.

vi. ***Floatation cost***: Higher the floatation cost of a particular source (in terms of broker’s commission, underwriting commission), lower is its component in the capital structure. For instance, if the floatation cost involved in equity is high, its component in the capital structure would be low.

vii. ***Rate of interest on debt***: High rate of interest on debt implies higher cost of debt, thereby, it becomes difficult to opt for debt in the capital structure.

4. The factors that will affect the fixed capital requirements of the company are as follows:

1. ***Type of business***: The amount of fixed capital required by a company depends, to a large extent, on the type of business that it deals in. Since 'S' Limited is a manufacturing firm (having a large operating cycle), thus it requires large fixed capital.

2. ***Scale of operations***: The scale of operations of the company is high implying that a larger amount needs to be invested in plants, land, building, etc. Thus, it requires large fixed capital.

3. ***Growth prospects***: Since the company is growing and expanding, thus it requires higher amount of fixed capital.

The factors that will affect the working capital requirements of the company are as follows:

1. ***Type of business***: The company would require large working capital as it is a manufacturing firm and involves a large operating cycle. That is, in this company the raw materials need to be converted into finished goods before they are finally sold. Therefore, it requires large working capital.

2. ***Scale of operations***: Since the company is operating on a large scale, thus it requires large working capital. This is because it need to maintain high stock of inventory and debtors.

3. ***Growth Prospects***: The company would require higher amount of working capital as it has higher growth prospects.

4. ***Seasonal factors related to operation***: The company would require high working capital as the demand for its product (i.e steel) is growing.