FINANCIAL MANAGEMENT

Unit 3: INVESTMENT & DIVIDEND DECISION

CAPITAL BUDGETING

Capital budgeting is long term planning for making and financing proposed capital outlays"- Charles T Horngreen.

FACTORS INFLUENCING CAPITAL BUDGETING

1. Availability of funds
2. Structure of capital
3. Taxation policy
4. Government policy
5. Lending policies of financial institutions
6. Immediate need of the project Earnings
7. Capital return
8. Economical value of the project
9. Working capital
10. Accounting practice

Methods of capital budgeting

Traditional methods

- Payback period
- Accounting rate of return method

Discounted cash flow methods

- Net present value method
- Profitability index method
- Internal rate of return

1. Payback Period measures the time in which the initial cash flow is returned by the project. Cash flows are not discounted. Lower payback period is preferred.

In case they are even, the formula to calculate payback period is:

$$\text{Payback Period} = \frac{\text{Initial Investment}}{\text{Cash Inflow per Period}}$$

When cash inflows are uneven, we need to calculate the cumulative net cash flow.

Decision Rule

Accept the project only if it's payback period is less than the target payback period.

ADVANTAGES AND DISADVANTAGES

Advantages of payback period are:

1. Payback period is very simple to calculate.

2. It can be a measure of risk inherent in a project. Since cash flows that occur later in a project's life are considered more uncertain, payback period provides an indication of how certain the project cash inflows are.

3. For companies facing liquidity problems, it provides a good ranking of projects that would return money early.

Disadvantages of payback period are:

1. Payback period does not take into account the time value of money which is a serious drawback since it can lead to wrong decisions. A variation of payback method that attempts to remove this drawback is called discounted payback period method.

2. It does not take into account, the cash flows that occur after the payback period.

2. Net Present Value (NPV) is equal to initial cash outflow less sum of discounted cash inflows. Higher NPV is preferred and an investment is only viable if its NPV is positive.

Advantages:

1. It recognizes the time value of money

2. It considers all cash flows over the entire life of the project in its calculations.

3. It is consistent with the objective of maximizing the welfare of the owners.

Limitations:

1. It is difficult to use.

2. It presupposes that the discount rate which is usually the firm's cost of capital is known. But in practice, to understand cost of capital is quite a difficult concept.

3. It may not give satisfactory answer when the projects being compared involve different amounts of investment.

3. Accounting Rate of Return (ARR) is the profitability of the project calculated as projected total net income divided by initial or average investment. Net income is not discounted.

Advantages:

1. It is very simple to understand and use.

2. It can be readily calculated using the accounting data.

3. It uses the entire stream of incomes in calculating the accounting rate.

Limitations:

1. It uses accounting, profits, not cash flows in appraising the projects.

2. It ignores the time value of money; profits occurring in different periods are valued equally.

3. It does not consider the lengths of projects lives.

4. It does not allow for the fact that the profit can be reinvested.

Decision Rule

Accept the project only if its ARR is equal to or greater than the required accounting rate of return. In case of mutually exclusive projects, accept the one with highest ARR.

4. Internal Rate of Return (IRR) is the discount rate at which net present value of the project becomes zero. Higher IRR should be preferred.

Advantages:

1. Like the NPV method, it considers the time value of money.

2. It considers cash flows over the entire life of the project.

3. It satisfies the users in terms of the rate of return on capital.

4. Unlike the NPV method, the calculation of the cost of capital is not a precondition.

5. It is compatible with the firm's maximising owners' welfare.

Limitations:

1. It involves complicated computation problems.

2. It may not give unique answer in all situations. It may yield negative rate or multiple rates under certain circumstances.

3. It implies that the intermediate cash inflows generated by the project are reinvested at the internal rate unlike at the firm's cost of capital under NPV method. The latter assumption seems to be more appropriate.

5. Profitability Index (PI) is the ratio of present value of future cash flows of a project to initial investment required for the project.

Decision Rule

Accept a project if the profitability index is greater than 1, stay indifferent if the profitability index is 1 and don't accept a project if the profitability index is below 1.

DIVIDEND

The term dividend refers to that portion of net profits which is distributed among the shareholders.

DIVIDEND POLICY

The term dividend policy refers to the policy concerning the amount of profit to be distributed as dividends. It refers to the decisions whether to retain earnings in the firm for capital investment and other purposes or to pay out the earnings in the form of cash dividend to shareholders.

FORMS OF DIVIDEND

1. CASH DIVIDEND- Cash dividend is the dividend which is distributed to the shareholders in cash out of the earnings of the business. It is the most commonly used term for the payment of dividend. Generally, the company which has enough cash balance is likely to pay dividend.

2. SCRIP DIVIDEND- During the shortage of cash and the company's cash position is temporarily weak and does not permit cash dividend in that case the company may declare dividend in the form of scrip or promissory note. This ensures or promises the shareholder, the dividend at a certain date in near future. The strong reason behind the issue of scrip dividend is to postpone due payment of cash for short time and the company is waiting for the conversion of current assets into cash in the course of operations.

3. BOND DIVIDEND- The Company may issue the bonds to its shareholders for long period. The issue of bond dividends increases the long-term ability of the company. This form of dividends is also not prevalent in India.

4. PROPERTY DIVIDEND- This involves a payment with assets other than cash. This form of dividend may be followed wherever there are assets that are no longer necessary in the operation of the business.

5. STOCK DIVIDEND OR BONDS SHARES- Stock dividend is the dividend which is paid to shareholders in kind .When stock dividend are paid, a portion of surplus is transferred to the capital account and shareholders are issued additional share certificates. This dividend is declared to only equity shareholders and such issue of shares increases the total number of share of the existing shareholding.

FACTORS INFLUENCING THE DIVIDEND POLICY

A firm's dividend policy is influenced by the large numbers of factors. Some factors affect the amount of dividend and some factors affect types of dividend. The following are the some major factors which influence the dividend policy of the firm.

1. Legal requirements

There is no legal compulsion on the part of a company to distribute dividend. However, there certain conditions imposed by law regarding the way dividend are distributed. Basically there are three rules relating to dividend payments. They are the net profit rule, the capital impairment rule and insolvency rule.

2. Firm's liquidity position

Dividend payout is also affected by firm's liquidity position. In spite of sufficient retained earnings, the firm may not be able to pay cash dividend if the earnings are not held in cash.

3. Repayment need

A firm uses several forms of debt financing to meet its investment needs. This debt must be repaid at the maturity. If the firm has to retain its profits for the purpose of repaying debt, the dividend payment capacity reduces.

4. Expected rate of return

If a firm has relatively higher expected rate of return on the new investment, the firm prefers to retain the earnings for reinvestment rather than distributing cash dividend.

5. Stability of earning

If a firm has relatively stable earnings, it is more likely to pay relatively larger dividend than a firm with relatively fluctuating earnings.

6. Desire of control

When the needs for additional financing arise, the management of the firm may not prefer to issue additional common stock because of the fear of dilution in control on management. Therefore, a firm prefers to retain more earnings to satisfy additional financing need which reduces dividend payment capacity.

7. Access to the capital market

If a firm has easy access to capital markets in raising additional financing, it does not require more retained earnings. So a firm's dividend payment capacity becomes high.

8. Shareholder's individual tax situation

For a closely held company, stockholders prefer relatively lower cash dividend because of higher tax to be paid on dividend income. The stockholders in higher personal tax bracket prefer capital gain rather than dividend gains.

9. Past Dividend Rate

The company while declaring dividend also have to take into consideration, the dividend declared in previous years.

10. Dividend Policy Of The Competitive Concern

This is one more factor which has to be considered while declaring dividend.

TYPES OF DIVIDEND POLICY

1. REGULAR DIVIDEND POLICY: - The payment of dividend at the usual rate is termed as regular dividend. The investors such as retired persons, widows and other economically weaker persons prefer to get regular dividend.

The following are some of the advantages of this type of policy.

a) It creates confidence among the shareholders.

b) The shareholders views dividends as a source of funds to meet their day-to-day expenses.

c) It stabilities the market value of the shares.

d) It establishes the profitable record of the company.

2. STABLE DIVIDEND POLICY: - This means consistency in the stream of dividend payments. It means payments of certain amount of dividend regularly. A Stable dividend policy may take any one of the following forms:-

1) CONSTANT DIVIDEND PER SHARE: - This means stream of dividend payments. If refers to a policy where the company pay fixed dividend per share irrespective of the level of earnings year after year. For this purpose dividend equalization fund will be created to pay fixed dividend in the year when the earnings are not good to pay such fixed dividends.

2) CONSTANT PAY OUT RATIO:- It refers to payment of a fixed percentage of net earnings as dividends every year. Here, the amount of dividend fluctuates directly with the earnings of the company.

3) STABLE RUPEE DIVIDEND + EXTRA DIVIDEND: - This refers to policy where the company declares low constant dividend and in the year of high profits pay extra dividends.