MB202: FINANCIAL MANAGEMENT

UNIT 4

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CURRENT ASSETS MANAGEMENT

A current asset, also known as a liquid asset, is any resource a company could use, turn into cash, or sell within a year. This includes cash in the bank, money that customers owe (accounts receivable), goods ready to be sold (inventory), and other investments that can be easily offloaded. Current assets are a company's quick cash reserve, ready to cover short-term bills or expenses.

Types of current assets

- Cash and cash equivalents
- Marketable securities
- Accounts receivable
- Inventory
- Supplies
- Prepaid expenses
- Other liquid assets

Current liabilities are an enterprise's obligations or debts that are due within a year or within the normal functioning cycle. Moreover, current liabilities are settled by the use of a current asset, either by creating a new current liability or cash. Current liabilities appear on an enterprise's Balance Sheet and incorporate accounts payable, accrued liabilities, short-term debt and other similar debts.

Current Liabilities Examples:

- Accounts Payable: Accounts payable are nothing but, the money owed to the manufacturers.
- Accrued Expenses: They are the bills which are due to a 3rd party but not payable, for instance, wages payable.
- Accrued Interest: Accrued Interest incorporates all interest that has been accumulated since previously paid.
- Bank account overdrafts (BAO): BAOs are the short term advances that are outlined by the bank for the purpose of overdrafts.

- Notes payable or Bank loans: It is the existing principal part of a long term loan.
- Dividends payable: They are the dividends stated by the enterprise's BOD (Board of Directors) that are due to be paid to the shareholders.
- Income Taxes payable: Income tax is a kind of tax that is owed to the government that is due to be paid.
- Wages: Wages is the money that is due to be paid to the employees.

WORKING CAPITAL

The amount of working capital can make or break a business. It is essential to an enterprise like oxygen is to the body. A company can make do without profits but can only sustain itself for a short time with this approach. Working capital is the difference between what a business currently owns and owes. It is calculated with the following formula:

Working Capital = Current Assets – Current Liabilities

Estimating working capital requirements is essential in projecting an accurate amount. With a working capital loan, businesses can finance their short-term needs and expenses like raw materials, payments, bills, salaries, taxes, etc. This ensures streamlined operations for the coming months or financial year.

Types of Working Capital

- **Permanent Working Capital**: It is the baseline amount of assets reserved by a company to run its operations during the year without difficulty. This includes the money needed to cover essential expenses, bills, etc. This capital depends on the company's size.
- **Regular Working Capital**: A type of permanent working capital, regular working capital funds daily operations like material purchases, salaries, etc.
- **Reserve Margin Working Capital**: As the name suggests, reserve margin working capital acts like a buffer during emergencies. The extra amount helps handle contingencies such as business depression, strikes, calamities, etc.
- **Variable Working Capital**: It is also known as fluctuating capital. It is invested only for a specific time in the company. Additionally, this capital changes with the business volume or the amount of assets it has at a particular time.
- **Seasonal Variable Working Capital**: This is seen in seasonal enterprises, which experience demand only during peak business seasons. Due to the sudden peak in

demand, the need for extra finances increases quickly. Examples include raw cotton, sugarcane, dairy products, etc.

- **Special Variable Working Capital**: Occasionally, a business may require extra funds to cater to exceptional circumstances or manage unplanned expenses. This is where special variable working capital compensates for these events.
- **Gross Working Capital:** This category includes the total amount invested in current business holdings. It includes cash, inventory, receivables, securities, and short-term investments. It is an indicator of the financial position of the company.
- **Net Working Capital**: Net working capital = current assets - current liabilities.
  If the net working capital is positive, it has enough funds to cover its expenses in the short term. Having adequate working capital is also a good indicator of a company's financial reliability. Therefore, more working capital translates to better opportunities to invest and grow in the long term.

Factors that Determine the Requirements of Working Capital

1. Sales: For any business, the size of the sale matters. To have a higher sales number, the business needs to maintain higher current assets in the form of inventory and cash at hand to sustain the operations and fulfil demand. Therefore, a business with a higher sales number requires higher regular working capital compared to a business with a lower sales turnover.

2. Length of the Operating Cycle: The operating cycle refers to the number of days it requires to acquire inventory, sell the inventory, and collect cash from the sale of inventory. A business with a longer operating cycle will have higher working capital requirements compared to a shorter operating cycle. For example, a chips manufacturer will have a shorter operating cycle compared to a real estate developer.

3. Inventory Management Policy: The working capital requirement also depends on the inventory management policy of the company. For example, if a company wants to stock all the raw materials before starting production, the working capital requirement will be very high as resources will get stuck until the operating cycle completes.

4. Size of Business: The working capital requirements go up with the growth in the size of the business and scale of operations. A company that operates on a large scale with multiple manufacturing units spread across different regions will have higher working capital needs but will have better economics due to better bargaining power compared to small business units.

5. Credit Policy: The credit policy also dictates the working capital requirements of the business. A small business has to depend on deferred payments to drive sales and secure business orders. In case of missed payments from clients, it hurts the working capital requirements. Also, if you have raised any working capital loan in the past or have any short-term liabilities, its repayment will add to the working capital costs.

6. Seasonality of Business: Many businesses don't generate enough sales throughout the year and are only season-specific. For example, businesses dealing in woollen garments, tourism industry, seasonal fruits exporters, etc. Such businesses experience a quick upsurge in sales that lasts a few weeks to months. During such a period, the business will require higher working capital requirements compared to the rest of the year to ensure competitiveness in the market.

7. Nature of Production Technologies: The nature of production technology incorporated in plants also impacts working capital needs. For example, if a plant uses a labour-intensive manufacturing process, the cost of wages will be higher compared to those plants that use automated production processes. A plant with an automated production process will require fewer workers, therefore the expenses like wages will be lower.

8. Contingencies: Risks in business also impact operational efficiency and working capital needs. Factors like inflation, and reduced demand due to changing trends in the market, impact the working capital requirements. All such factors increase the working capital requirement and the business needs to increase the contingency provisions to keep the business operations running.

Estimating Working Capital Requirements

A firm must estimate in advance as to how much net working capital will be required for the smooth operations of the business. Only then, it can bifurcate this requirement into permanent working capital and temporary working capital. This bifurcation will help in deciding the financing pattern i.e., how much working capital should be financed from long term sources and how much be financed from short term sources.

Different Methods of Estimating Working Capital Requirements

There are different approaches available to estimate the working capital requirements of a firm. There are a number of different methods that can be used to estimate working capital requirements.

- **Cash flow method-** The cash flow method is a popular option for estimating working capital requirements. With this method, you forecast your company's future cash flow and use that information to estimate the amount of working capital you will need. The cash flow method simply projects future cash inflows and outflows to determine how much working capital will be required.
- **Historical data method-** As the name suggests, the historical data method uses information from the company's past to estimate future working capital requirements. This approach is based on the premise that a company's future working capital needs will be similar to its past needs. To calculate working capital using this method, you first need to determine your company's average cash conversion cycle (CCC) over time.
- **Industry and trade standards method-** This approach can be used to get a general idea of the minimum amount of working capital required for a specific industry or trade. To use this method, you will need to find industry-specific data on the average level of inventory, accounts receivable, and accounts payable. This information can be found in surveys or reports from trade associations or other similar organisations.
- **Ratio analysis method-** With the ratio analysis method, businesses look at their financial statements and calculate some key financial ratios. The ratios used in the ratio analysis method are the current ratio, quick ratio, and inventory turnover. Even if you own a small business, such financial ratios help to give a snapshot of how well the business is doing and how much working capital is needed.
- **Management judgment method-** This method relies on the knowledge and experience of management to come up with an estimate. To use this method, management first needs to consider the company's past working capital needs. They will then look at any changes that have happened within the company or industry which could impact future working capital requirements. After considering all this, management will come up with an estimate for the company's future working capital needs.

WORKING CAPITAL POLICY

A working capital policy refers to a company's rules and guidelines to manage its working capital efficiently. The primary focus is to maintain a balance between the business's assets and liabilities, ensuring financial stability and operational efficiency. With the right working capital financing policy, a company owner can provide enough liquidity to meet everyday operations and minimise the cost of cash holding and short-term assets.

Types of Working Capital Policies

Working capital policy is a strategic financial approach to managing a company's short-term assets and liabilities. It plays a crucial role in establishing a company's growth, stability, and risk management and guiding decisions about finance resources. The most common working capital policies in financial management include the following:

- **Conservative Policy:** As its name suggests, a conservative working capital policy is safe and effective. It primarily focuses on reserving current assets to clear current liabilities and handling emergencies arising during the business lifecycle. While the policy provides ample funds to tackle various situations, the company has a smaller amount to re-invest in the business. So, evaluating the company’s growth plan before choosing this working capital policy is essential.
- **Aggressive Policy:** This type of working capital policy is best suited for businesses in a secure position. It works by reserving some current assets and establishing creditors’ terms that allow repayment later and debt collection immediately. Achieving these parameters efficiently helps maintain minimal working capital and supports business growth. However, it is a high-risk policy that requires weighing the substantial gains against the company’s risk appetite.
- **Matching Policy:** A well-established business feels more comfortable with the idea of taking risks. In such situations, opting for a matching policy is appropriate. Such companies have enough assets to pay their current liabilities, and they have a lean working capital. This policy is ideal for companies gathering momentum and breaking into a new expansion phase. It provides a bigger amount to re-invest into the business by holding back the working capital.

MANAGEMENT OF CURRENT ASSETS:

Cash management

Cash is one of the current assets of a business. It is needed at all times to keep the business going. A business concern should always keep sufficient cash for meeting its obligations. Any shortage of cash will hamper the operations of a concern and any excess of it will be unproductive. Cash is the most unproductive of all the assets. While fixed assets like machinery, plant, etc. and current assets such as inventory will help the business in increasing its earning capacity, cash in hand will not add anything to the concern. It is in this context that cash management has assumed much importance.

Motives for Holding Cash

1. Transaction Motive: A firm needs cash for making transactions in the day-today operations. The cash is needed to make purchases, pay expenses, taxes, dividend, etc. The cash needs arise due to the fact that there is no complete synchronization between cash receipts and payments. Sometimes cash receipts exceed cash payments or vice-versa. The transaction needs of cash can be anticipated because the expected payments in near future can be estimated.

2. Precautionary Motive: A firm is required to keep cash for meeting various contingencies. Though cash inflows and cash outflows are anticipated but there may be variations in these estimates. For example a debtor who was to pay after 7 days may inform of his inability to pay; on the other hand a supplier who used to give credit for 15 days may not have the stock to supply or he may not be in a position to give credit at present. In these situations cash receipts will be less than expected and cash payments will be more as purchases may have to be made for cash instead of credit. Such contingencies often arise in a business.

3. Speculative Motive: The speculative motive relates to holding of cash for investing in profitable opportunities as and when they arise. Such opportunities do not come in a regular manner. These opportunities cannot be scientifically predicted but only conjectures can be made about their occurrence. The price of shares and securities may be low at a time with an expectation that these will go up shortly. Such opportunities can be availed of if a firm has cash balance with it.

4. Compensatory Motive: To meet unexpected contingencies or operative actions which occur during the functioning of the organisation. Eg. Accidents, Compensation, Benefits to workers like PF, Bonus, Health Insurance etc.

CASH MANAGEMENT

Cash management has assumed importance because it is the most significant of all the current assets. It is required to meet business obligations and it is unproductive when not used. Cash management deals with the following:

(i) Cash inflows and outflows

(ii) Cash flows within the firm

(iii) Cash balances held by the firm at a point of time.

Cash Management needs strategies to deal with various facets of cash. Following are some of its facets.

(a) Cash Planning: Cash planning is a technique to plan and control the use of cash. A projected cash flow statement may be prepared, based on the present business operations and anticipated future activities. The cash inflows from various sources may be anticipated and cash outflows will determine the possible uses of cash.

(b) Cash Forecasts and Budgeting: A cash budget is the most important device for the control of receipts and payments of cash. A cash budget is an estimate of cash receipts and disbursements during a future period of time. It is an analysis of flow of cash in a business over a future, short or long period of time. It is a forecast of expected cash intake and outlay.

Both short term and long term cash forecasts may be made with help of following methods.

(a) Receipts and Disbursements method

(b) Adjusted net income method

- **Receipts and Disbursements method**: In this method the receipt and payment of cash are estimated. The cash receipts may be from cash sales, collections from debtors, sale of fixed assets, receipts of dividend or other income of all the items; it is difficult to forecast the sales. The sales may be on cash as well as credit basis. Cash sales will bring receipts at the time of sales while credit sale will bring cash later on. The collections from debtors will depend upon the credit policy of the firm.
- **Adjusted Net Income Method**: This method may also be known as sources and uses approach. It generally has three sections: sources of cash, uses of cash and adjusted cash balance. The adjusted net income method helps in projecting the company's need for cash at some future date and to see whether the company will be able to generate sufficient cash.

Methods of Accelerating Cash Inflows

1. Prompt Payment by Customers: In order to accelerate cash inflows, the collections from customers should be prompt. This will be possible by prompt billing. The customers should be promptly informed about the amount payable and the time by which it should be paid. Another method for prompting customers to pay earlier is to allow them cash discount.

2. Quick Conversion of Payment into Cash: Cash inflows can be accelerated by improving the cash collecting process. Once the customer writes a cheque in favour of the concern the collection can be quickened by its early collection. There is a time gap between the cheque sent by the customer and the amount collected against it. This is due to many factors,

(i) Mailing time, i.e. time taken by post office for transferring cheque from customer to the firm, referred to as postal float;

(ii) Time taken in processing the cheque within the organization and sending it to bank for collection, it is called lethargy and

(iii) Collection time within the bank, i.e. time taken by the bank in collecting the payment from the customer’s bank, called bank float.

3. Decentralised Collections: A big firm operating over wide geographical area can accelerate collections by using the system of decentralized collections. A number of collecting centres are opened in different areas instead of collecting receipts at one place. The idea of opening different collecting centres is to reduce the mailing time for customer’s dispatch of cheque and its receipt in the firm and then reducing the time in collecting these cheques.

4. Lock Box System: Lock box system is another technique of reducing mailing, processing and collecting time. Under this system the firm selects some collecting centres at different places. The places are selected on the basis of number of consumers and the remittances to be received from a particular place.

Methods of Slowing Cash Outflows

1. Paying on Last Date: The disbursements can be delayed on making payments on the last due date only. It is credit is for 10 days then payment should be made on 10 th day only. It can help in using the money for short periods and the firm can make use of cash discount also.

2. Payments through Drafts: A company can delay payments by issuing drafts to the suppliers instead of giving cheques. When a cheque is issued then the company will have to keep a balance in its account so that the cheque is paid whenever it comes. On the other hand a draft is payable only on presentation to the issuer.

3. Adjusting Payroll Funds: Some economy can be exercised on payroll funds also. It can be done by reducing the frequency of payments. If the payments are made weekly then this period can be extended to a month. Secondly, finance manager can plan the issuing of salary cheques and their disbursements.

4. Centralisation of Payments: The payments should be centralized and payments should be made through drafts or cheques. When cheques are issued from the main office then it will take time for the cheques to be cleared through post. The benefit of cheque collecting time is availed.

5. Inter-bank Transfer: An efficient use of cash is also possible by inter-bank transfers. If the company has accounts with more than one bank then amounts can be transferred to the bank where disbursements are to be made. It will help in avoiding excess amount in one bank.

6. Making use of Float: Float is a difference between the balance shown in company's cash book (Bank column) and balance in passbook of the bank. Whenever a cheque is issued, the balance at bank in cashbook is reduced. The party to whom the cheque is issued may not present it for payment immediately.

Determining Optimum Cash Balance

A firm has to maintain a minimum amount of cash for settling the dues in time. The cash is needed to purchase raw materials, pay creditors, day-to-day expenses, dividend etc. An appropriate amount of cash balance to be maintained should be determined on the basis of past experience and future expectations. If a firm maintains less cash balance then its liquidity position will be weak. If higher cash balance is maintained then an opportunity to earn is lost. Thus, a firm should maintain an optimum cash balance, neither a small nor a large cash balance. There are basically two approaches to determine an optimal cash balance, namely,

(i) Minimizing Cost Models and

(ii) Preparing Cash Budget. Cash budget is the most important tool in cash management.

MODELS OF CASH MANAGEMENT

1. Cash Budget

A cash budget is an estimate of cash receipts and disbursements of cash during a future period of time. In the words of Solomon Ezra, a cash budget is "an analysis of flow of cash in a business over a future, short or long period of time. It is a forecast of expected cash intake and outlay." It is a device to plan and control the use of cash. Thus a firm by preparing a cash budget can plan the use of excess cash and make arrangements for the necessary cash as and when required. The cash receipts from various sources are anticipated. The estimated cash collections for sales, debts, bills receivable, interests, dividends and other incomes and sale of investments and other assets will be taken into account. The amounts to be spent on purchase of materials, payment to creditors and meeting various other revenue and capital expenditure needs should be considered. Cash forecasts will include all possible sources from which cash will be received and the channels in which payments are to be made so that a consolidated cash position is determined.

2. Baumol's Model

William J. Baumol has suggested a model for determining the optimum balance of cash based upon carrying and transaction costs of cash. The carrying cost refers to the cost of the holding cash i.e. interest; and transaction cost refers to the cost involved in getting the marketable securities converted into cash,

3. Miller-Orr Model

The Miller–Orr model argues that changes in cash balance over a given period are random in size as well as in direction. The cash balance of a firm may fluctuate irregularly over a period of time. The model has specified two control limits for cash balance. An upper limit, H, beyond which cash balance need not be allowed to go and a lower limit, L, below which the cash level is not allowed to reduce. The cash balance should be allowed to move within these limits. If the cash level reaches the upper control limit, H, then at this point, a part of the cash should be invested in marketable securities in such a way that the cash balance comes down to a predetermined level called return level, R, If the cash balance reaches the lower level, L then sufficient marketable securities should be sold to realize cash so that cash balance is restored to the return level, R. No transaction between cash and marketable securities is undertaken so long as the cash balance is between the two limits of H and L.

RECEIVABLE MANAGEMENT

Account receivables refer to the outstanding invoices or money which is yet to be paid by customers. Until it is paid, such invoices or money is accounted as accounts receivables. Also known as bills receivables. You need cash all the time to keep your business running smoothly and ensuring the accounts receivables are paid on time is essential to manage cash flow efficiently. And as the term suggests, management of your accounts receivable is called receivable management. Basically, the entire process of defining the credit policy, setting payment terms, sending payment follow ups and timely collection of the due payments can be defined as receivables management. Management of Receivables is also known as:

- Payment Collection
- Collection Management
- Accounts Receivables

Objective of Receivables Management

The main objective of receivables management is to efficiently convert outstanding payments from customers into liquid assets, thereby minimising the negative impact on cash flow and working capital. Here are the main objectives -

- **Maximize Cash Flow**: The primary goal is to minimise the lag between providing goods/services and receiving payment. This promotes healthy cash flow, allowing your business to operate smoothly and pay its own bills on time.
- **Reduce Days Sales Outstanding (DSO):** DSO measures the average time customers pay their invoices. Lower DSO translates to faster cash inflow and improved financial stability.
- **Minimize Bad Debt**: Unpaid invoices become bad debt, impacting your bottom line. Effective receivables management aims to prevent bad debt and write-offs through proactive strategies.
- **Optimize Working Capital**: By accelerating cash collection, you free up working capital for investments, expansions, or covering operational expenses.
- **Maintain Positive Customer Relationships**: While collecting payments is critical, good receivables management prioritises open communication and customer understanding. This fosters long-term positive relationships and encourages prompt payments.

Scope of receivable management

When you do sales on credit, you would certainly need to keep track of the due amounts that your parties owe you. All such dues from your parties will be your outstanding receivables. Managing the outstanding receivables can be critical to your business because it not only helps to understand how much your parties owe you, but also helps you to recover the dues on time and use it for your business, as needed.

- Record and track dues

- Use credit period
- Keep a close eye on long-pending bills
- Payment performance of your customer

INVENTORY MANAGEMENT

Inventory management is the supervision of a company's inventory, including the processes for producing, ordering, storing, and selling products in the market. This includes managing the warehousing and processing of raw materials, components, and finished products. Effective inventory management keeps a company organized. It also provides critical data to help businesses respond to trends, avoid breakdowns in supply chain management, and maintain profitability.

The importance of inventory management

Inventory management impacts production, warehouse costs, and order fulfilment. Having effective inventory management helps contain costs and ensure businesses have the correct amount of stock. It also cuts down on excess inventory. Efficient inventory management can streamline production and fulfilment processes for a business. Here are some benefits of an inventory management strategy:

- Lower costs and saves money
- Prevent overspending on warehouse storage
- Minimize storage needs
- Reduce losses to improve cash flow
- Forecast sales trends
- Satisfies customers with timely deliveries

Inventory management challenges

The main challenges in inventory management is keeping too much inventory that the company is unable to sell, lacking the inventory to fulfill orders that come in, and not tracking inventory correctly. Here are some other challenges:

- Poor or outdated processes and inventory management systems
- Changes in customer demand as needs and desire change
- Difficulty navigating a warehouse to locate specific products

Types of inventory

There are four main types of inventory, as follows:

- **Raw goods:** Raw goods are materials used in the manufacturing of products. Usually, they appear in the early phases of production. Raw materials can include metal, plastic, fabric, or wood that are used to create finished goods. They may come from one or more suppliers.
- **Work-in-progress (WIP):** WIP is a partially finished product that is waiting to be completed. WIPs take account of production costs such as labor, raw materials, and equipment, which are then later attributed to cost of goods.
- **Finished goods:** Finished goods are products that are available in stock for customers to buy. When a WIP is complete, it becomes part of finished goods inventory.
- **Maintenance, repair, and operations goods (MRO):** MRO are materials and equipment that are used in production but do not count as part of the final product. This may include personal protective equipment, office and cleaning supplies, and more.
- Less common types of inventory might include safety stock, packing materials, cycle inventory, service inventory, transit, theoretical, excess and maintenance, and decoupling inventory. Every company has different ways of categorizing its inventory.

Inventory management methods

Inventory management methods vary depending on business structures and sizes but ultimately enhance operations by reducing waste and managing costs. The following are some common methods:

1. Just in time (JIT)

Just-in-time (JIT) inventory management aims to maximize efficiency and lower costs by coordinating inventory arrival with the start of production. The goal of this method is to keep as little inventory on hand as possible and still meet a high production volume level for the product's demand. To have a successful JIT inventory business, you'll need proper forecasting of needs and close relationships with dependable suppliers.

Benefits:

- Reduces waste on unnecessary stock
- Lower costs by avoiding having unused goods
- Avoids having more storage space for inventory than necessary

2. Material requirements planning (MRP)

Material requirements planning (MRP) is a supply planning system that helps manufacturing businesses determine the inventory requirements to meet a product's demand. MRPs function based on demand and bill of materials (BOM) by examining the types of materials needed, the required amount of each material, and the manufacturing completion date.

Benefits:

- Gives businesses a balanced inventory
- Allows businesses to have the right amount of material for production
- Eliminates manual processes, like looking up past sales and existing inventory

3. Economic order quantity (EOQ)

Economic order quantity (EOQ) is a formula used to calculate the optimal order size to meet demand and stay within budget. EOQ is useful for any business, large or small, that manages inventory. The goal is to reduce the amount of over-ordering and waste, lower the cost of storage, and maximize quantity discounts offered by vendors.

Benefits:

- Minimizes storage and holding costs
- Helps maintain inventory levels that match customer demand
- Provides specific numbers for how much inventory to hold

4. Day of sales inventory (DSI)

The day sales in inventory (DSI) is a sales monitoring and inventory tracking measurement tool. The DSI is also called the average age of inventory because it calculates how long it takes for a business to sell its inventory and considers how long the current inventory will last.

Benefits:

- Reduce cost from overspending on inventory
- Effectively manage cash flow
- Prevent waste from outdated inventory
- Helps determine the statistical data for a company's inventory management, tracking, and sales

DIVIDEND

According to the Institute of Chartered Accountants of India, dividend is "a distribution to shareholders out of profits or reserves available for this purpose."

"The term dividend refers to that portion of profit (after tax) which is distributed among the owners / shareholders of the firm."

"Dividend may be defined as the return that a shareholder gets from the company, out of its profits, on his shareholdings."

In other words, dividend is that part of the net earnings of a corporation that is distributed to its stockholders. It is a payment made to the equity shareholders for their investment in the company.

Dividend is a reward to equity shareholders for their investment in the company. It is a basic right of equity shareholders to get dividend from the earnings of a company. Their share should be distributed among the members within the limit of an act and with rational behaviour of directors.

DIVIDEND POLICY

"Dividend policy determines the ultimate distribution of the firm's earnings between retention (that is reinvestment) and cash dividend payments of shareholders." "Dividend policy means the practice that management follows in making dividend pay-out decisions, or in other words, the size and pattern of cash distributions over the time to shareholders."

1. Stable Dividend: In this pattern, shareholders receive a fixed dividend amount occasionally. This stability in distributing dividends is unaffected by the earnings of the company. With this dividend policy, the company pays shareholders a dividend even if they are making losses.
2. Regular Dividend: Companies following a regular dividend pattern fix a percentage of their profits to be given as dividends. With a higher yield, the company pays a higher and lower dividend when it makes a smaller profit.
3. Irregular Dividend: Here, the company decides to pay a special dividend to the shareholders on a case-to-case basis. The company chooses the dividends per its priority. For example, if the company plans to expand, it might reinvest its profits and decide not to pay dividends.
4. No Dividend: A company following a no-dividend policy retains all its profits and does not distribute them among its shareholders.

Objectives of a Dividend Policy

The objectives of a dividend policy in a company are multifaceted and can vary depending on the organization's goals and circumstances. However, some common objectives include:

- Provide Shareholder Return: A dividend policy rewards shareholders by distributing a portion of profits as dividends. This attracts new investors and provides a return on investment.
- Maintain Investor Confidence: Consistent dividend payments boost investor confidence in the company's financial stability, positively affecting the stock price and market perception.
- Capital Allocation: A dividend policy decides how much of earnings should be retained for reinvestment (e.g., for expansion, research) and how much should be distributed as dividends.
- Tax Considerations: A dividend policy takes into account tax implications for shareholders.
- Access to Capital: Dividends attract income-oriented investors, broadening the investor base and providing access to a different class of shareholders.
- Signal Financial Health: Consistent dividend payments signal financial stability and confidence in future prospects.
- Flexibility: The dividend policy can adapt to changing economic conditions and business needs.
- Competitive Advantage: A well-structured dividend policy can distinguish a company from others in the same industry and attract long-term investors.
- Align Interests: Dividends align the interests of management and shareholders, benefiting executives holding stock options or shares.
- Shareholder Satisfaction: Consistent dividend payments foster loyalty and reduce the likelihood of activist shareholders or hostile takeovers.

Factors Affecting a Dividend Policy

1. Profitability: A company will declare a dividend only if it has made a profit. The company's profits also determine the proportion of dividends distributed among the shareholders.

2. Dividend Payment History: Generally, a company with a history of paying dividends to its shareholders keeps its dividend amount stable. These are dividend stocks where most investors park their money to earn a regular dividend income.

3. Growth Plans and Availability of Funds: A business might retain its profits if it has plans to reinvest them to expand. However, if the company's retained earnings are enough to fund its expansion, it may pay dividends.

4. Dividend Trends in the Industry: Companies might match the dividend trends that exist in their industry to retain their shareholders.

Types of Dividends

If a company has decided to pay dividends to its shareholders, the next crucial decision it needs to make is the dividend pay-out ratio. The dividend pay-out ratio measures how much you can get for each of the shares you hold.

Dividend Pay-out Ratio = Annual dividend per share / Earnings Per Share (EPS)

EPS is a figure that describes the profit amount per share of the company. Companies must also decide what form of dividend they will pay-out to shareholders. There are four major types of dividends.

1. Stock Dividends: Dividends can be given by granting additional shares to existing shareholders. A company can issue less than one-fourth of its previously issued stock in stock dividends. However, if the company provides additional shares in the form of a stock split, it can surpass this limit.

2. Cash Dividends: Cash dividends are amongst the popular forms of dividends in India. Here, the company pays its shareholders a fixed amount per share. For example, if the dividend rate is 5% and you have 100 shares of the company, your cash dividend value would be 5 x ₹100 = ₹500.

3. Property Dividends: Sometimes, a company issues a non-financial dividend to its shareholders, such as a property dividend. These dividends can include giving shares of a subsidiary company (another company under a parent brand) as dividends. The value of the property dividend is considered against the asset's current market price. For example, Marvel Entertainment is a subsidiary of Walt Disney Entertainment. If Disney gives Marvel's shares as dividends, they are called property dividends.

4. Scrip Dividends: A scrip dividend is an 'I-owe-you' note that a company issues to its shareholders when it does not have enough dividends. This promissory note indicates that the company will pay dividends to its shareholders later. These dividends are usually cash dividends.

THE VARIOUS THEORIES OF DIVIDENDS

- **Bird-in-the-Hand Theory:** This suggests that investors prefer to receive dividends now rather than in the future because future dividends are uncertain.
- **Tax Preference Theory:** This theory suggests that investors prefer capital gains over dividends because capital gains are taxed at a lower rate than dividends.
- **Agency Cost Theory:** Dividends are a way for managers to signal their confidence in the firm's future prospects to investors. By paying dividends, managers show they have enough cash to meet current obligations and still have money left to distribute to shareholders.
- **Information Signalling Theory:** Firms that pay higher dividends are seen as having more stable earnings and better growth prospects, which can lead to higher stock prices and lower capital costs.
- **Clientele Effect Theory:** This theory suggests that different investors prefer different dividend policies. For example, income-oriented investors may prefer high dividend pay-outs, while growth-oriented investors may prefer low or no dividend pay-outs. Therefore, firms may adopt different dividend policies to attract and retain different types of investors.

DIVIDENDS AND VALUE OF THE FIRM

The company's Board of Directors makes dividend decisions. They are faced with the decision to pay out dividends or to reinvest the cash into new projects. The trade-off between paying dividends and retaining profits within the company. The dividend policy decision is a trade-off between retaining earnings v/s paying out cash dividends.

Dividend policies must always consider two basic objectives:

- Maximizing owners' wealth
- Providing sufficient financing