

Foundations of Accounting & Finance

Prof. Arun Kumar Gopaldaswamy

Department of Management Studies - IIT Madras

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Lecture – 21

Ratios Analysis Part III - Dividend and Liquidity Ratios

I. Dividend Policy

Dividend policy refers to the decision adopted by a company regarding the distribution of profits to its shareholders. Essentially, dividends represent a portion of the company's earnings that are distributed to the equity holders. Dividend policy outlines how and when dividends will be paid out to shareholders, taking into account various factors such as the company's financial performance, growth prospects, capital requirements, and investor preferences. The dividend policy can vary among companies, with some choosing to pay out dividends regularly, while others may opt to reinvest profits back into the business for future growth. Ultimately, the dividend policy reflects management's decisions on balancing the interests of shareholders with the company's long-term objectives. Dividend yield and dividend payout ratio are the two important ratios with respect to dividend policy.

1) Dividend yield

Dividend yield is key metric investors use to evaluate the return on their investment in a particular stock. Let us break down how dividend yield is calculated and its significance.

When a company declares a dividend, it is typically expressed as a percentage of the face value of the shares. For example, if a company announces a 300 percent dividend on shares with a face value of 5 rupees each, it means shareholders will receive 300 percent of 5 rupees, which is 15 rupees per share.

Now, let us consider an investor who purchases shares in the market at a price of 1500 rupees per share. For these shares, the investor will receive a dividend of 15 rupees per share.

Dividend yield is calculated by dividing the dividend per share by the market price per share. In this case, the dividend yield would be calculated as follows:

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price per share}}$$

For example, if an investor bought shares at 1500 rupees and received a dividend of 15 rupees per share, the dividend yield would be $15/1500=0.01$, or 1 percent.

Analysts typically use the average market price of the stock to calculate dividend yield, as it provides a more comprehensive view over time. However, investors may choose to use the price at which they purchased the shares to calculate their personal dividend yield.

2) Dividend payout ratio

The dividend payout ratio is a crucial metric for investors to understand how much of a company's profits are being distributed to shareholders as dividends. It is calculated as follows:

$$\text{Dividend yield} = \frac{\text{Dividend}}{\text{Net Income}}$$

The dividend payout ratio represents the proportion of a company's net income that is paid out to shareholders in the form of dividends. It is calculated by dividing the total dividends paid by the company by its net income or profit after tax (PAT).

For example, if a company's net income for the year is \$1,000 and it pays out \$400 in dividends, the dividend payout ratio would be $400/1000=0.4$, or 40 percent. A dividend payout ratio of 40 percent would indicate that the company is distributing 40 percent of its net income as dividends, leaving 60 percent to be retained for reinvestment or other uses.

A high payout ratio may indicate that the company is committed to returning profits to shareholders but may have limited funds available for reinvestment in the business. On the contrary, a low payout ratio may suggest that the company is retaining more earnings for growth opportunities or to strengthen its financial position.

Investors often compare the dividend payout ratio of a company with its peers and industry averages to assess its dividend sustainability and attractiveness as an investment opportunity.

II. Liquidity Position

Understanding the liquidity position of a company is crucial for stakeholders, as it indicates how readily the company can meet its short-term financial obligations. Liquidity refers to the ease with which assets can be converted into cash to meet short-term liabilities. It is important for a company to have sufficient liquidity to cover its immediate expenses, such as payroll and creditor payments.

Assets and liabilities are classified as either long-term or short-term. Long-term assets include fixed assets like land, buildings, and machinery, while short-term assets consist of items like receivables and cash in the bank that can be quickly converted into cash. Similarly, long-term liabilities include obligations such as long-term loans, while short-term liabilities encompass items like trade payables and outstanding expenses that need to be settled in the near future.

Companies typically use short-term assets to meet their short-term liabilities. For example, if a company receives cash from sales, it can use that cash to pay suppliers for raw materials. However, if there is a timing gap between when payments are due and when cash is received, the company may need to borrow funds to cover the shortfall.

A company's ability to meet its short-term obligations is assessed by comparing its current assets (short-term assets) to its current liabilities (short-term liabilities). Current assets include cash, accounts receivable, and inventory, while current liabilities include accounts payable and short-term borrowings. This difference between current assets and liabilities is known as the working capital requirement.

The liquidity position is evaluated by examining whether the company's current assets are sufficient to cover its current liabilities. A healthy liquidity position means that the company has enough short-term assets to meet its short-term obligations without relying on borrowed funds. Conversely, a poor liquidity position may indicate that the company is facing cash flow difficulties and may struggle to meet its immediate financial commitments. Following are the major ratios to assess the liquidity of a company:

1) Current Ratio

The current ratio, obtained by dividing current assets by current liabilities, measures a company's liquidity. While textbooks may advocate for current assets to be twice the current liabilities, this varies across industries. Therefore, pinpointing a specific number is challenging. The main focus remains on assessing whether current assets adequately covers current liabilities, thereby indicating liquidity.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

2) Quick Ratio

The quick ratio, also known as the acid-test ratio, provides a more stringent measure of liquidity compared to the current ratio. It excludes inventory from the calculation because inventory is often considered less liquid due to its difficulty in converting to cash quickly.

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

Among the various current assets, inventory stands out as particularly "sticky" or difficult to convert into cash promptly. This is because inventory, whether it's raw materials, work-in-progress, or finished goods, often requires time to be sold or processed before generating cash. Unlike cash or bank balances, which can be readily accessed, inventory may need to undergo manufacturing, processing, or find suitable buyers before being converted into cash.

Therefore, when calculating the quick ratio, inventory is excluded to provide a more accurate assessment of a company's ability to meet short-term obligations with its most liquid assets, such as cash and accounts receivable.

How to convert receivables?

To quickly convert debtors, businesses often employ strategies such as discounting and factoring:

1. **Discounting:** This involves approaching a bank or financial institution with promissory notes or accounts receivable and requesting immediate cash in exchange for a discounted amount of the expected payment. For example, if a business expects to receive 1 lakh on February 24th but needs immediate cash, they may approach a bank to discount the promissory note. The bank might offer an amount less than 1 lakh to cover for the financing cost. Subsequently when the promissory note is honoured by the payee the bank will collect the full payment of 1 lakh.
2. **Factoring:** Factoring is similar to discounting but involves selling of accounts receivables to a third-party financial institution known as a factoring agent. The factoring agent buys the receivables at a discounted rate, providing immediate cash to the business. The factoring agent then collects the full amount owed from the debtor when the payment becomes due. This allows businesses to convert their receivables into cash quickly. The only advantage of this is that the receivables get out of the books of the company whereas in the case of discounting it does not.

Both discounting and factoring provide businesses with immediate liquidity by converting their outstanding receivables into cash, making them relatively easier to convert to cash compared to other assets like inventory.

Why is inventory sticky?

Inventory is considered sticky because it's not easily convertible into cash compared to other current assets. Imagine you're an automobile manufacturer operating on an assembly line. By the end of March, your inventory might consist of partially assembled cars; some with engines but no tires, others with only shells and no engines. These incomplete units are unsellable in their current state, making them challenging to convert into cash.

Even raw material inventory, such as tires purchased from a manufacturer, can be difficult to sell. While tires themselves are marketable, potential buyers would typically prefer purchasing directly from a manufacturer rather than from another automobile company. This can force companies to offer discounts to offload inventory, further complicating the conversion process.

Therefore, inventory, including raw materials and semi-finished goods, are considered sticky because of the challenges involved in selling these assets promptly.

To account for this, we use the quick ratio, which assesses whether current assets excluding inventory are sufficient to cover current liabilities. By subtracting inventory from current assets, we focus on assets that can be quickly converted to cash.

3) Days payable

Days payable is crucial for suppliers of raw materials to the company. As a supplier, you are keen on getting your money back within a reasonable timeframe. So, you want to know how long it takes for the company to settle its dues.

To calculate this, we look at the average number of days it takes for the company to pay its creditors. Let us break it down.

First, we need to determine the average daily raw material usage. Suppose during the year 2020-21, the total raw material usage amounts to 20 lakhs. Dividing this by 365 gives us an average daily usage of approximately 5479 rupees.

Now, let us consider the creditors listed on the balance sheet as of March 31, 2021, which amounts to 3 lakhs. By dividing the creditors by the average daily usage one can possibly obtain the average days material usage that is blocked in creditors or the value expressed in terms of average number of days material usage. In this case, it is approximately 55 days.

So, what does this mean? Even if you offer a 30-day credit term, the company takes an average of 55 days to pay its creditors. This indicates the average number of days payable, highlighting the payment efficiency of the company

$$\text{Days payable} = \frac{\text{Creditors}}{\text{Average daily raw material usage}}$$

4) Days receivable

Days receivable is another crucial aspect for credit providers. Why? Because if you don't collect money from your debtors, how will you settle your dues? It's essential to know, on average, how long it takes for you to collect payments for your sales.

Let us break it down. Typically, sales are made on credit. So, the first step is to determine the average daily sales. Suppose the total sales for the year 20-21 amount to 35 lakhs. That translates to an average of approximately 9589 rupees per day.

Now, let us consider the debtors listed on the asset side of the balance sheet, which amount to 7 lakhs. How many days of sales does this represent? It is simple: divide the debtors by the average daily sales. In this case, it is approximately 73 days.

So, what does this mean? If it takes you 73 days to collect payments, and you're selling on 30-day credit terms, your collection process is not as efficient as it should be. Similarly, if your payment

terms for purchases are 30 days, but you're taking 55 days to pay, your payment efficiency is also lacking.

$$\text{Days receivables} = \frac{\text{Debtors}}{\text{Sales} \div 365}$$