VIDYA BHAWAN BALIKA VIDYA PITH

शक्ति उत्थान आश्रम लखीसराय बिहार

Class 12 commerce Sub. BST. Date 8.9.2020

Teacher name – Ajay Kumar Sharma

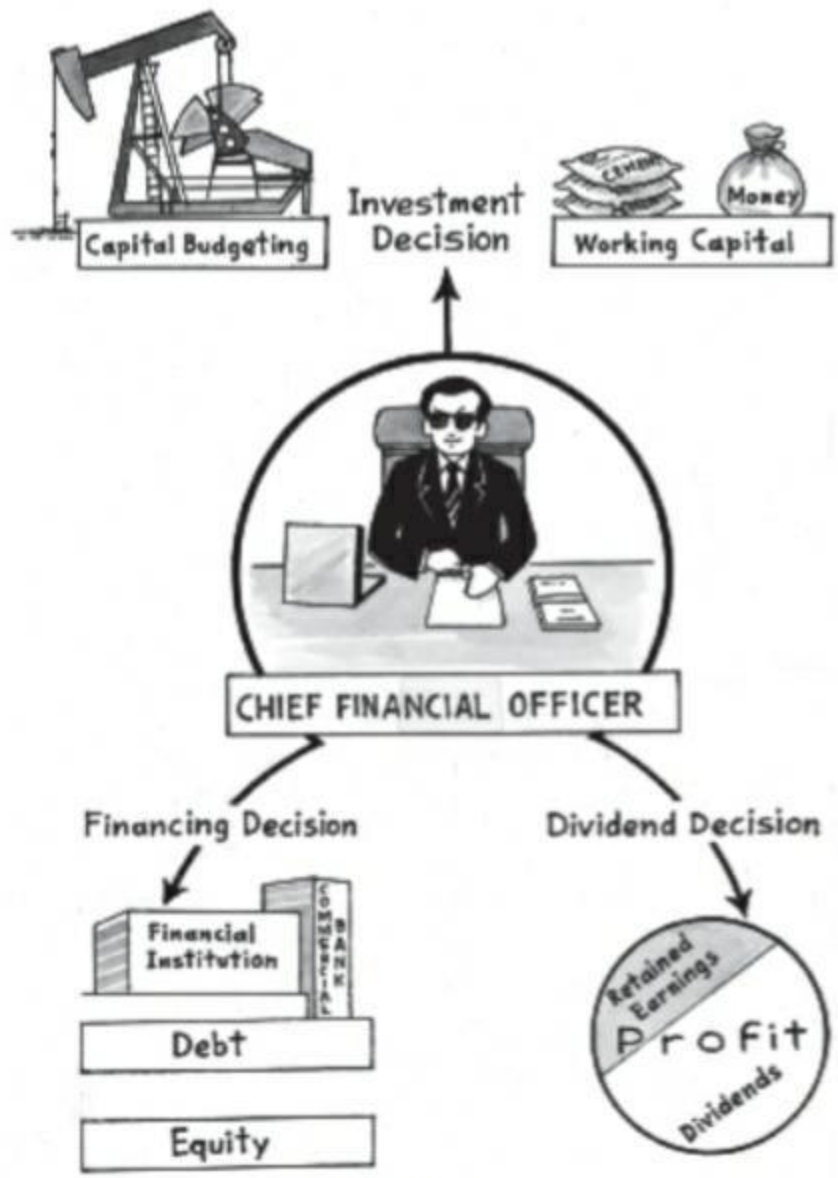
BUSINESS FINANCE

Financing Decision

This decision is about the quantum of finance to be raised from various long-term sources (short-term sources are studied in working capital management).

It involves identification of various available sources. The main sources of funds for a firm are shareholders funds and borrowed funds. Shareholders funds refer to equity capital and retained earnings. Borrowed funds refer to finance raised as debentures or other forms of debt. A firm has to decide the proportion of funds to be raised from either source based on their basic characteristics. Interest on borrowed funds have to be paid regardless of whether or not a firm has made a profit. Likewise, borrowed funds have to be repaid at a fixed time. The risk of default on payment is known as financial risk which has to be considered by a firm likely to have insufficient shareholders to make these fixed payments. Shareholders funds on the other hand involve no commitment regarding payment of returns or repayment of capital. A firm, therefore, needs to have a judicious mix of both debt and equity in making financing decisions, which may be debt, equity, preference share capital and retained earnings.

The cost of each type of finance is estimated. Some sources may be cheaper than others. For example, debt is considered the cheapest of all sources, tax deductibility of interest makes it still cheaper. Associated risk is also different for each source e.g., it is necessary to pay interest on debt and redeem the principal amount on maturity. There is no such compulsion to pay any dividend on equity shares. Thus, there is some amount of financial risk in debt financing. The overall financial risk depends upon the proportion of debt in the total capital. The fund raising exercise also costs something. This cost is called floatation cost. It also must be considered while evaluating different sources. Financing decision is, thus



Financial Decisions

Factors Affecting Financing Decision

The financing decisions are affected by various factors. Some of the important factors are as follows:

(a) Cost: The cost of raising funds through different sources are different. A prudent financial manager would normally opt for a source which is the cheapest.

(b) Risk: The risk associated with different sources is different.

(c) Floatation Costs: Higher the floatation cost, less attractive the source.

(d) Cash Flow Position of the Business: A stronger cash flow position may make debt financing more viable than funding through equity.

(e) Level of Fixed Operating Costs: If a business has high level of fixed operating costs (e.g., building rent, Insurance premium, Salaries etc.), It must opt for lower fixed financing costs. Hence, lower debt financing is better. Similarly, if fixed operating cost is less, more of debt financing may be preferred.

(f) Control Considerations: Issues of more equity may lead to dilution of management's control over the business. Debt financing has no such implication. Companies afraid of a takeover bid may consequently prefer debt to equity

(g) State of Capital Markets: Health of the capital market may also affect the choice of source of fund. During the period when stock market is rising, more people are ready to invest in equity. However, depressed capital market may make issue of equity shares difficult for any company.