The Factors Influencing Financial Decisions:

A finance manager has to exercise a great skill and prudence while taking financial decisions since they affect financial health of an enterprise over a long period of time. It would, therefore, be in fitness of things to take the decisions in the light of external and internal factors. We shall now give a brief account of the impact of these factors on financial decisions.

1. External Factors:

External factors refer to environmental factors within which a business enterprise has to operate. These factors are beyond the control and influence of the management. A wise management adopts policies that will be most suited to the present and prospective socio-economic and political conditions of the country.

The following external factors enter into decision making process:

State of Economy:

At a time when the entire economy is enveloped into state of uncertainty and there is no ray of hope of recovery in the ensuing years, and considerable amount of risk is associated with investment it would be worthwhile on the part of a finance manager neither to take up new investment activities nor to carry further the expansion programmes.

On the contrary, if it is found that the economy is likely to recover from the current gloomy state of affairs, the finance manager should not miss the chance of exploiting investment opportunities. For that matter, he should after evaluating the economic viability of project in hand; select the most profitable project in advance so that when the opportunity crops up the same is seized upon.

Economic condition of the country influences financing decision also. In times of prosperity when investors have keen desire to invest more and more savings the firm can garner the desired amount of funds from the market by floating securities. But it should be remembered that the firm will have to offer higher interest rate (dividend rate) because interest rates tend to harden under pressure of demand.

This would consequently increase cost of capital of the firm. To minimise cost of financing finance manger should insist more on debenture financing as benefits on trading on equity would tend to minimise cost. In times of depression, raising outside capital poses grave problem. Under such condition, greater emphasis should be laid on internal financing and for that purpose reserve position of the company will have to be strengthened.

Dividend policy of a firm should also be attuned to changing economic conditions. If it lurks that the business is entering upon a period of depression, conservatism should be followed, for the business may need all of its cash resources to carry it safely through the period of decline until its sales soar. During boom period there is tendency among firms to offer higher dividend rate to mobilise funds from the market.

The management is, therefore, constrained to declare the dividend at the higher rate. This should not pose any financial problem before the management since earning of the firm improves sharply in times of prosperity. There is also a strong possibility for the management to adopt conservative dividend policy during boom periods so that the firm may get sufficiently large amount of resources to finance growth requirements.

Structure of Capital and Money Markets:

Where institutional structure of capital and money markets is well developed and organised with a multitude of financial institutions supplying long-term as well as short-term financial assistance and investors are venturesome evincing keen interest in security dealings in stock market, business entrepreneurs will not have to encounter much problem in procuring even substantially large amount of capital.

Various alternate sources are available and businessmen have a freedom to decide about the optimal financing mix so that cost of capital is reduced. Furthermore, the firm's ability to adjust sources of funds in response to major changes in need for funds increases.

Not only does it enable entrepreneurs to use the type of funds that is most readily available at a given period of time but it also enhances their bargaining power when dealing with a prospective supplier of funds.

In the absence of organised capital market entrepreneurs find it difficult to procure large amount of resources from the market. They have to raise capital from closely held circles. In such a state of affairs, policy of internal financing is pursued so as to enable the firm to draw upon its resources in times of need for funds.

State Regulations:

A finance manager must take investment decisions within the legal framework provided by the state. In a socialist country like India, entrepreneurs are not free to take up any venture they like. For example in India, Industrial Policy Resolution 1956, spells out clearly the industrial fields in which the Govt. will enter and those where private sector will have freedom to operate.

Through industrial licencing system the Government seeks to ensure that the private sector business entrepreneurs do not intrude into prohibited areas. Under such circumstances a finance manager has to consider the viability of only those projects which are permissible by the Government.

As per SEBI guidelines, a new company set up by entrepreneurs without a track record is permitted to issue capital to public only at par. Other companies have freedom in pricing their public issues, provided certain conditions are fulfilled.

The equity capital to be subscribed, in any issue to the public, by promoters should not be less than 25 percent of the total issue of equity capital for amounts up to Rs. 100 crore and 20 percent of the issue for amounts above Rs. 10 crore.

Taxation Policy:

Taxation is the most predominant factor influencing business decisions since it takes away the bigger slice of business income. While deciding to invest in projects, a finance manager has to keep in view the existence of tax incentives.

For example, recently the Government of India decided to provide tax holiday facility to entrepreneurs seeking to invest in roads, bridges, airports, ports and rail systems for ten years. Tax holiday facility for five years has also been provided to those engaged in providing telecommunication services.

Further, a finance manager, has to decide as to which method of depreciation should be followed that may reduce tax burden. There are numerous methods of charging depreciation, important being Straight Line method, Straight Line method. Diminishing Balance method and Annuity method.

From the stand point of taxation, Straight Line method is very useful since in this method depreciation is charged at twice the normal depreciation rate which ultimately reduces the tax liability. It may be argued in this regard that tax savings generated in the initial years because of charging depreciation at higher rate will be compensated by the increased tax liability in the subsequent years when depreciation will be charged at lower rate.

However, on a closer scrutiny it would appear that the present value of tax savings in initial years would always be higher than the present value of the additional tax liability in the subsequent years. Thus taxation influences the choice of method of depreciation.

Likewise, tax liability of a firm fluctuates depending upon method of inventory valuation. There are different methods of inventory valuation, viz., LIFO, FIFO. A finance manager must ascertain in advance as to which method will be helpful in minimising the tax burden.

Taxation also influences the capital structure decision. Other things being equal, debt financing is always cheaper from taxation point of view because interest on debt is a tax deductible expenditure while dividends are not.

Taxation enters into dividend decision too. High corporate tax rates lower the amount of earnings left for dividend distribution which, in consequence, tend to lower dividend rate. However, recent studies have revealed that high rates would not necessarily influence dividend rate particularly when tax burden is shifted on consumers.

This tendency is widely prevalent in India. Very often the government in its bid to promote corporate savings levies special tax on those companies who declare dividend at a higher rate. For example, in India dividend tax @ 7.5% was levied in 1964 and companies declaring dividend in excess of 10 per cent were required to pay this tax.

In 1968 this tax was taken back. Taxation also plays an important part in deciding the form of dividend. Generally, dividend is distributed in the form of cash and shares. Dividend distributed in shares is popularly known as bonus shares.

While dividend received by shareholders in cash is subject to tax in their hands, bonus shares are exempted from the tax. That is why shareholders particularly those in the high income tax bracket prefer to receive dividends in shares rather than in cash.

Requirements of Investors:

While taking financing decision a finance manager should also give due consideration to the requirements of potential investors. There may be different types of investors with varying degree of safety, liquidity and profitability notions.

Investors who are conservative and liquidity conscious would like to hold such securities as may assure them certainty of return and return of principal amount after the stipulated period of time. There may be, on the other hand, investors who are not as liquidity conscious, venturesome and who have greater preference for profitability.

Such type of investors would prefer to invest their savings in equities. Thus, the management seeking to raise substantially large amount of capital for this undertaking has to issue different types of securities so as to cater to as large a number of investors as may be possible.

Further, investors' psychology changes with the variation in economic and business conditions. In times of economic turmoil and business depression even venturesome investors would like to hold senior securities while during the period of economic prosperity shares receive premium even at the hands of those investors who are not so venturesome. Finance manager should, therefore, be well aware of the prevailing temper of the investing class.

Dividend policy must be geared to investors in general and existing stockholders and potential stockholders in particular. This helps in maximisation of the market value of the firm. Problem of ascertaining optimum allocation of business earnings between retention and dividends because of the diverse investment goals, tax brackets and alternate investment opportunities of the current and potential investors may prompt management to rationalize the soundness of such other factors as influence dividend policy as risk avoidance or maintenance of market price.

Lending Policy of Financial Institutions:

Lending policy of financial institutions may also influence investment decisions of a firm. If financial institutions follow the policy of concessional financing to priority projects and decide to grant loans to non- priority projects on a very strict terms and conditions, naturally the finance manager while taking investment decisions would provide greater weightage to the former group of projects in relation to the later ones, if other things remain the same.

Further, while deciding about the sources of funds that have to be tapped for raising capital, lending policy of the financial institutions should be carefully examined. Sometimes, financial institutions grant financial assistance on such terms and conditions as may not be acceptable to the management.

For instance, financial corporations in India usually insist on maintenance of debt-equity ratio for medium and large scale project as 1.5:1 and promoter's contribution of 20-25 percent of the project cost while considering loan application of a firm. Under such a condition, a firm seeking loan from the financial institutions must maintain the ratio of debt to equity at a level desired by them.

The finance manager must, therefore, make suitable adjustment in financing mix of the firm in such ways as to conform to the desired pattern. The finance manager will have, therefore, to examine into the expediency of getting loans from the institutions under the afore-stated condition.

2. Internal Factors:

Internal factors refer to those factors which are related with internal conditions of the firm such as nature of business, size of business, expected return, cost and risk, asset structure of business, structure of ownership, expectations about regular and steady earnings, age of the firm, liquidity in company funds and its working capital requirements, restrictions in debt agreements, control factor and attitude of the management.

Within the economic and legal environment of the country finance manager must take financial decision, keeping in mind the numerous characteristics of the firm. Impact of each of these factors upon financial decisions will now be discussed in the following lines.

Nature of Business:

Nature of business may influence the pattern of investment in a firm, firm's make-up of capitalisation and the firm's dividend policy. In manufacturing and public utility concerns bulk of the funds have to be employed in acquiring fixed assets while in trading concerns substantially large amount of funds is invested in current assets, and fixed assets claim a nominal proportion.

As among manufacturing industries, fixed assets requirements in capital goods industries would always be higher than in consumer goods industries.

Impact of nature of business activities on make-up of capitalisation should also be closely examined. It is generally found that firms engaged in production of staple goods will have stability in their level of earnings as demand of their products is very likely to be uniformly steady both in times of business depression and boom. In view of this, they could place heavier reliance on debt for acquiring additional funds for the business.

Contrary to this, level of business earnings is fluctuating in the case of industrial undertakings engaged in production of non-essential products because demand of their products changes in consonance with economic oscillations. Management of such companies would not choose to burden themselves with fixed charges.

Similarly, public utility concerns and industrial concerns manufacturing essential products because of their steady and slow rising earnings may pursue liberal dividend policy to declare higher dividend rate. But trading concerns and those dealing in luxurious products would be committing blunder in pursuing such dividend policy.

Prudent dividend policy in such concerns is one that lays more emphasis on greater retention of earnings so that the firm could build huge reserves in periods of prosperity and the same could be utilised to maintain dividend rate at times when earnings of the firm nose-dive.

Size of Business:

Firms engaged in the same line of activity may have different investment patterns depending primarily on the scale of their operations. Relatively larger amounts of funds are required to acquire fixed assets in larger concerns because these companies automate their process of production which smaller firms cannot afford.

Furthermore, small firms with their limited amount of capital can carry on their affairs by renting or leasing plant and equipment and building while larger firms usually construct their own buildings to house the factory and acquire plant and machinery to carry on production work.

Smaller firms because of their poor credit position have limited access to capital and money market in contrast to their larger counterparts. Investors are usually averse to invest in shares and debentures of smaller organisations. Furthermore, these smaller organisations do not have adequate amount of fixed assets to offer as security for securing loan. This is why management in the smaller organisations has to arrange capital from closely held circles.

Even if smaller firms are in comfortable position to raise equity share capital, their owners would be hesitant to place issues for public offering with a view to maintaining their control over the organisation. On the contrary, larger concerns find it easier to procure needed funds from different sources of capital and money markets.

Management in such concerns, therefore, considers it useful to employ more and more doses of debt to meet business requirements since this course of action would tend to reduce the cost of capital.

Dividend decision of a firm is also influenced by its size. Because of difficult access to external sources of financing, smaller organisations have to depend on internal sources of financing and for that matter the management may pursue conservative dividend policy to retain larger proportion of business earnings.

The management does not encounter any problem in persuading the shareholders who are few in number to agree to their policy. The shareholders should also have no objection in such policy because this will help minimize their tax liability. However, in larger concerns having large number of shareholders the management cannot always adopt a particular policy because wishes of the shareholders would not be common.

Expected Return, Cost and Risk:

Major factors influencing investment decision are expected return on the project, its cost and the risk associated with the project. Where dispersion of outcomes is known and all projects are equal in risk, finance manager would naturally go for that investment proposal which leads to highest revenues in relation to cost.

Where different projects have varying degrees of riskiness, allowance will have to be made for the absorption of risk. This is usually done by adjusting the discount rate, i.e., rate of interest which is employed to discount future net cash flows of the project to present values.

Thus, the greater the dispersion of outcomes, higher the discount rate is employed which means that returns will be reduced at a higher rate because of the allowance made for the risk assigned to the eventuality of their realisation.

For a risk-less investment, risk-free discount rate is employed. As risk increases, higher and higher discount rates are employed. In this way after making appropriate adjustments for risk factor final course of action is chosen.

A finance manager should take into consideration earning prospects of investment projects in hand while taking dividend decision. Supposing a firm has large number of investment projects with vast earning potentialities sufficient to exhaust its earnings and the shareholders of the firm have strong preference for current dividends a finance manager in such situation must impress upon the shareholders about the strong need to retain more and more earnings and pursue strict dividend policy.

However, where the projects in hand promise only normal return, the management should follow liberal dividend policy to keep up with preferences of shareholders. Contrary to this, if the shareholders are indifferent between dividends and capital gains a finance manager must accept all those investment projects that would carry income above the break-even point and funds for these projects should be arranged out of retained earnings.

Asset Structure of Firm:

Firms with sufficient amount of fixed assets must rely on debt to take advantage of cheaper source of financing. For example, public utilities and steel companies can depend heavily on debentures for raising capital as they can mortgage their assets for securing loan.

But trading concerns whose assets are mostly receivables and inventory values which are dependent on the continued profitability of the firm should place less reliance on long-term debt and should depend more on short-term debt for their financial requirements.

Structure of Ownership:

In private companies whose ownership is concentrated in a few hands the management can find it easier to persuade the owners to accept strict dividend policy in the interest of the firm. But in public limited companies having large number of shareholders with varying desires the finance manager must insist on the pursuance of liberal dividend policy.

Probabilities of Regular and Steady Earnings:

While planning about the make-up of capitalisation and deciding about the relationship between debt and equity the finance manager must visualize the trends of earnings of the firm for the past few years. Where the firm’s past earnings have been reasonably stable and the same tendency is likely to continue in future, reliance on debt may be desirable.

Where earnings of the firm have been irregular in the past but when averaged over a period of years give a fair margin over the preferred stock dividend, the management may issue preferred shares to raise funds. When earnings of the firm fluctuated violently in the past and the future earnings cannot be predicted with reasonable certainty, it will incur risk in issuing debt.

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Degree of stability in level of earnings is a potent factor influencing dividend policy. But such a policy will prove dangerous to companies whose earnings are subject to great fluctuations. In such companies it would be prudent to declare lower dividend rate even when the business earnings are fairly high in order to use them to maintain the dividend rate in times of adversities.

Age of the Firm:

Investors are generally loath to employ their funds in new ventures because of relatively greater risks involved. Lenders too feel shy of lending because of their poor capital base. Consequently, new enterprises have to encounter considerable problems in assembling funds from the market. They approach underwriters and stock brokers and pay them higher commission and brokerage for sale of their securities.

Thus, a new firm will have small share of debt in its total capitalisation. Even if new enterprises are in comfortable position to garner funds by issue of debentures, a finance manager should, as far as possible, avoid bringing in heavy dose of debt, for in that case a large chunk of business income might be eaten away by interest on loans leaving a little amount for dividend distribution and retention for further financing.

The company's ability to raise funds by means of debt in the ensuing years might be circumscribed by restriction in debt covenants. In sharper contrast to this, existing ventures may not face considerable problem in raising funds from the market because of high credit standing in market.

Such concerns usually float debentures for their additional long-term financial requirements with a view to reaping benefit of trading on equity. They also draw upon a part of the reserves built out of the past earnings for covering their additional financial needs. Thus, there is every likelihood of relatively greater amount of dilution of debt in the capitalisation of older firms.

Age of the firm goes far to determine its dividend policy. A new and growing concern whose access to capital market is limited must follow strict dividend policy to keep away a larger portion of the business earnings for financing growth requirements. Existing ventures, however, need not follow such policy.

Liquidity Position of the Firm and Its Working Capital Requirements:

A finance manager must consider cash position of the firm and firm's needs for funds to meet maturing obligations and working and fixed capital requirements while taking dividend decisions. Dividends are generally paid out of cash. Care should, therefore, be exercised by the finance manager to make sure that cash is readily available to distribute dividends.

Availability of large surplus does not always mean the availability of cash in the firm particularly when a large amount of sale has been done on credit. By the time sale proceeds tied in receivables are collected the firm may need funds to buy materials to process production.

Thus, despite the presence of profit and even the availability of cash, working capital requirements of the firm may be so imminent that may warrant the pursuance of conservative dividend policy.

Again, if a company has sufficient amount of cash resources in hand at the time when some loans taken in the past are due it would be advisable to finance manager to conserve cash to meet the past obligations and adjust dividend pattern accordingly.

In many cases firms rely on their earnings for financing the acquisition of fixed assets. In such circumstances too the management must not be liberal in dividend distribution at least for some years even though a sizeable profit has been earned.

Restrictions in Debt Agreements:

The provisions of debt contracts should be carefully examined while deciding about forms of raising capital and establishing dividend policy since most indentures contain provisions that prevent the use of additional debt or issue of debentures of the earlier type.

They also restrict the payment of dividends and sometimes disallow their payment until certain conditions are fulfilled. Needless to say, finance manager should make available to the Board of Directors a brief of all contractual provisions that affect the capital structure and dividends in any way.

Management Attitude:

Above all, financial decisions are influenced by the attitude of the management. Management attitudes that most directly influence the choice of financing and dividend policy are those concerning control of the enterprise and risk.

Management desiring to maintain control of the firm would like to raise additional funds needed by means of debentures and preferred stock which do not affect controlling position of the management in the firm.

However, if company borrows more than what can be serviced by it; there is every risk of losing all control to creditors. It is, therefore, better to sacrifice a measure of control by some additional equity financing rather run the risk of all control to creditors by bringing in additional doses of debt. In such a situation, finance manager should not be very much liberal in dividend distribution.

Management attitude towards risk also determines the pattern of capitalisation of the firm. Conservative management would always prefer to tread on beaten path and would always avoid incurring fixed obligations for raising additional capital even though recourse to debt financing may be advantageous.