Debt-Equity Mix

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An organization, whether in the growth or maturity phase, is faced with financial decisions that affect the whole firm's productivity. Several tools exist for financial managers to determine how the business funds its current and future operations. Management sets the direction in determining whether to utilize debt or equity financing:

Equity	**Debt**
Payment of Dividends Not Tax-deductible	*Tax-deductible Payments on Interest*
No Necessary Collateral	*Values Needed for Collateral*
Firms Providing Equity Tend to be Assertive Since They Partake in Returns	*Firms Providing Debt Tend to be Conservative; Want to Remove All Capable Risks*
Firm Control is Shared; Due to This, Limitations May be Created	*Minimal Effect on Firm's Control*
No Repayment or Refinancing; Retained Fully	*Either Refinanced or Repaid*
Shareholders Take Part in Above-Average Returns	*Provides Opportunity for Leverage of Above-Average Returns*

Management must be able to accurately analyze the above comparison against the type of market that exists and the firm's current financial position. The use of leverage can be an advantage if the cost of debt is lower than the firm's total asset returns. In this

instance, debt maximization can reap rewards. If this is not the case, maximizing equity would be the ideal course of action.

Obtaining the best mix for the firm in question will be based on the shareholder's long-term value, and the final numbers about its growth. Consequently, the mix may be toggled several times to accommodate unique business situations. In the early years of the firm, it is likely there is a lack of cash on hand or collateral to exchange for debt; this company requires equity in order to develop. If already profitable, the firm can utilize debt.

Dividend Policy

The dividend policy for the firm will dictate regulations it creates and puts into action; these guidelines determine how dividend payments are made to shareholders. The policies, if successfully implemented, strengthen the relationship between managerial decision-makers and shareholders. Because shareholders, specifically the "common stockholder alone who directly controls the business" (Block, Hirt, 2004, p.505), management's interests should focus on maximizing shareholder returns.

The company's policies should be clear to stockholders; this creates a simpler process of making dividend return projections, and augments investor confidence. Contrarily, an unclear dividend policy makes these projections more difficult to analyze, thus potentially negatively affecting shareholder confidence.

Cost of Debt

Debt as a cost is "measured by the interest rate, or yield, paid to bondholders" (Block, Hirt, 2004, p. 313). Through the use of the formula to calculate approximate yields to maturity, the firm can determine how much of the debt has to be paid before

taxes. With the understanding that the interest payments for debt is tax-deductible, the real cost of debt is calculated after taxes, produced by multiplying the yield to maturity by one, minus the tax rate.

Cost of Retained Earnings

A large number of companies rely on their sources of internal cash to determine ownership or equity; this is considered retained earnings, which "represent the past and present earnings of the firm minus previously distributed dividends" (Block, Hirt, 2004, . 318). These earnings are owned by shareholders, confirmation of this ownership proven by law. The method of use of these earnings can be directed by the company, providing shareholders with dividends or reinvesting them into the company for future research and development, product launches or marketing campaigns.

References:

Block. Hirt. (2004). *Long-Term Financing*. Common and Preferred Stock Financing. New York: The McGraw-Hill Companies.

Block. Hirt. (2004). *The Capital Budgeting Process*. The Cost of Capital. New York: The McGraw-Hill Companies.