Capital Structure

Every organization requires funds to run and maintain its business. Capital structure (or financial plan) refers to the composition of long-term source of funds such as debentures, long-term debts, preference and ordinary share capital and retained earnings (reserves and surpluses). A company procures funds by issuing various types of securities, i.e., ordinary shares, preference shares, bonds and debentures.

Thus the long term finance can be raised by ~~issue~~ ~~of~~ ~~its~~ ~~shares~~ ~~and~~ ~~the~~ ~~amount~~ ~~to~~ ~~be~~ ~~raised~~ ~~though~~ following securities:

(a) Fixed cost bearing securities (debentures and preference share).

(b) Variable cost bearing securities (ordinary shares).

This security mix affects the financial stability of the company. If a company fails in the efforts in maintaining the security mix, its capital structure will be imbalanced which may affect its profitability. So, a company should maintain a fair balance between these two types of securities.

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Features Of Qualitities of Optimum or sound Capital structure:

(i) Minimum Risk: Capital Structure should ensure minim-um risk. The use of excessive debt threatens the solvency of the firm because it involves a fixed commitment to pay the interest irrespective of the profits.

(ii) Simplicity: The capital structure should be simple, so far as possible. Simplicity means that in adition to equity and preference capital, the minimum type of long-term securities should be issued. Initially only equity and preferences shares should be issued and debt instruments should be issued at a later stage.

(iii) Flexibility: The capital structure should be adequately flexible so that it may be altered when needed. Use of debt makes the capital structure more flexible because it can be raised when needed and redeemed when not required.

(iv) Maximum profitability: Capital structure of the company must provide maximum return to equity shareholders. A large amount of debt can be used by the firm to maximise its profitability, otherwise the firm should refrain the sources of their choice. But in case the firm's credit standing is poor, the firm will not be able to get finance from the source of its choice.

~~for unlimited period~~ which helps in shareholders wealth maximisation. Also remember that more debt generally implies a greater chance of bankruptcy, which is extremely expensive.

(x) Financial Flexibility: Capital structure of a firm should be flexible. The should be capable of raising additional funds without undue delay and cost, whenever needed and it should also be able to decrease the funds by redeeming the preference capital and debentures when the funds are not needed. It should also be able to substitute one source of finance for another to ~~each~~ achieve savings.

(xi) Legal requirements: There are some important guidelines on shares and debentures which are issued by government from time to time. While designing its capital structure, the firm should consider these guidelines and also the relevant provision of different ~~its tax~~ laws framed by the Government.

(xii) Credit standing of the firm: Firms which enjoy high credit standing from the viewpoint of investors and lenders in the capital market are in an advantageous position to raise finance on easy terms and from or individual investors. Some investors are ready to take risk who prefer capital gains and hence, equity shares are suitable to them.

(vii) Capital market conditions: Capital market condition go on changing from time to time. Sometimes there may be depression while at other times there may be boom conditions in the capital market. If the share market is depressed, the company should not issue equity shares, but issue debentures because the investors would prefer safety than profitability.

(viii) Period of finance: Period of finance also plays a curcial role in determining the capital structure of a firm. A firm can issue redeemable debentures or preference shares, when the finance is required for a limited period. For example; for 5 year, firm can issue 5 years redeemable debentures or preference shares. But equity share capital is the best source when the firm needs finance for unlimited period.

(ix) Tax position: All of we know that interest on debt is tax deductible, which makes debt attractive as a source of financing. Hence, debt can be accepted as a tax-sheltered source of finance.

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the risk of loss of control, the companies ~~perfer~~ prefer to issue preference shares or debentures because they do not have voting rights and elect the directors.

(iv) Degree of Competition: If there is prefect competition in an industry, the firms in the industry should use relatively a greater proportion of equity than debt. On the other hand, the industries which do not have high degree of competition will have a tendency of stables sales and therefore, the firm engaged in such type of industry can afford to use more debt.

(v) Cost of Capital: The capital structure should provide for the minimum cost of capital. Cost of capital is the rate that must be earned in order to satisfy the required rate of return of the firm's investors. It can also be defined as the rate of return on investments at which the price of a firm's equity share will remain unchanged.

(vi) Requirement of investors: The requirement of investors is yet another factor that determine the capital structure of business. Investors may be institutionall investors number of restrictions on further borrowing of the company.

Factors Determining the Capital Structure;

(i) Nature and Size of the business; Capital structure decision are also influenced by the nature and size of the business. A public utility concern has different capital structure as compared to other manufacturing concern. Public utility concerns may employ more of debt because of stability and regularily of their earnings.

(ii) Regularity of earnings; The entities, which have regular and increasing sales and earnings may resort to higher debt, i.e., high degree of leverage in their capital structure. This is because such entities will not face any difficulty in paying the interest and debts on time.

(iii) Control; The existing management of the company does not want to lose their control over the company. Equity shareholders have a right to vote and appoint director in the meetings of the company and hence, in case the company raises funds through issue of new equity shares and control the Company. To avoid

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from employing debt capital.

(V) Minimum Cost of Capital: Cost of capital means interest on debts or dividend on shares. Thus optimum Capital structure should include sufficient amount of debt since it is the cheapest source of finance.

(VI) Sufficient liquidity: Liquidity means the ability of the firm to pay interest as well as principal in time. A firm is considered liquid if it is able to pay the interest and principal under reasonably predicted adverse conditions.

(VII) Legal requirements: Capital structure should fulfill all the legal requirement in retaining the control over the company. Debt holders do not possess voting rights in company's meetings and hence cannot elect the directors of the company whereas equity shareholders possess voting rights.

(VIII) Avoidance of unnecessary restrictions: Capital structure should avoid unnecessary restrictions on the firm. For instance, term loans from financial institutions should be avoided because these institutions impose a

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Meaning and Definition of Capital structure:
The term 'capital structure' refers to the proportion between the various long-term sources of finance in the total capital of the enterprise. The major sources of long-term finance are as follows:

(I) Proprietor's Funds
(II) Borrowed Funds

(I) 'Proprietors fund': mean equity share capital, preference share capital, reserves and surpluses (i.e. retained earnings). It is also called as equity.

(II) 'Borrowed fund': means long-term debts such as loans from financial institutions. It is also called as debt.

According to Weston and Brigham, "Capital structure is the permanent financing of the firm represented by long-term debts, preferred stock and net worth".

According to R.H. Wessel, "Capital structure refers to the long-term sources of funds employed in the business enterprise".