**CAPITAL STRUCTURE, THEORIES OF CAPITAL STRUCTURE**

Capital structure is the mix of equity as owner’s capital and debt as creditors capital which is considered to be optimal for the firm. Capital structure decisions are very important for an organization because they determine whether the firm will be successful or not. The decisions involve balancing capital requirements of the frim and shareholders’ growth expectations by avoiding dilution of the firm’s shares in additional share issues, risk avoidance and returns maximization and at the same time increasing capacity of production and value creation in the firm. Usually debt is considered to be risky source of capital from the firm’s viewpoint because interest expense has to be paid regardless of the firm succeeding in making profits or not.

It is therefore a rational decision for finance experts and employees to utilize internal sources of capital financing including ordinary shares and retained earnings as equity capital components before considering debt financing capital sources like debentures. The aim and objective of the finance manager should be to maximize shareholders’ worth and welfare. Debt financing sources like issuing of debentures requires for a careful evaluation of the interest rates on debenture and debt (long term bank loans) when the firm cannot access any other capital sources or is making losses.

THEORIES OF CAPITAL STRUCTURE

Capital structure theories are agreed upon concepts in financing sources and uses of funds in a business organization. The following are the important theories of capital structure;

1. Pecking order theory show that managers will choose the security with least information costs for financing their firm
2. Signaling theories show that managers knowledge signals information to the industry when they choose the type of capital for financing their firm
3. Contracting cost theory demonstrates that firms will pick the source of financing with the least cost of capital.
4. Agency theory examines various conflicts between interests of stakeholders as management, creditors and shareholders of the firm in relation to maximizing the value of the frim
5. Trade-off theory examines the relationship between market value of the firm and determination of the optimal capital structure of the frim
6. The Modigliani and miller theory examines how capital structure decision is affected by costs of finance and losses of a firm