Sources of Capital

Finance is an important input for any type of business and is needed for working capital and for permanent investment. The total funds employed in a business are obtained from various sources. Some of the funds are permanently held in the business, such as share capital and reserves (**equity**), some others are held for a long period such as long-term borrowings or debentures (**debt**).

Capital Structure represents the total long-term investment in a business firm. It includes funds raised through ordinary and preference shares, bonds, debentures, term loans from financial institutions, earned revenue, capital surpluses, etc.

An appropriate capital structure should incorporate the following features:

1. **Flexibility**: A sound capita1 structure, must be flexible. The consideration of flexibility gives the financial manager ability to alter the firm's capital structure with a minimum cost and delay warranted by a changed situation. It should also be possible for the company to provide funds whenever needed to finance its profitable activities.
2. **Profitability**: A sound capital structure is also one that also possesses the feature of profitability, i.e., it must be advantageous to the company. It should permit the maximum use of leverage at a minimum cost with the constraints. Thus a sound capital structure tends to minimize 'cost' of financing and maximize earnings per share (EPS).
3. **Solvency**: A sound capital structure should also have the feature of solvency, i.e., it should use the debt capital only up to the point where significant risk it not added. As has been already observed the use of excessive debt threatens the solvency of the company.
4. **Conservation**: The capital structure should be conservative in the sense that the debt capacity of the company should not exceed. The debt capacity of a company demands on its ability to generate future cash flows. It should have enough cash to pay creditors fixed charges and principal amount. It should be remembered that cash insolvency might also lead to legal insolvency.
5. **Control**: The capital structure should involve minimum risk of loss of control of the company.

A careful consideration of these criteria points the, conflicting nature. For example the use of debt capital is more economical but the same capital adds to the financial risk of the company. As such the emphasis given to each of the elements will differ from one company to another. Also the characteristic features of a company may consider these and additional criteria.

Difference between debt and equity

	Basis	Debt	Equity
1.	Date of maturity	Debt has a fixed date of maturity when it is either repaid or converted into equity shares.	Equity has perpetual life i.e. it is not to be repaid unless the company is wound up.
2.	Claim	Debt has a prior claim both on annual cash flows in terms of interest and on the assets of the company in case of liquidation.	Equity has a residual claim i.e. there are surplus funds after payment of interest an tax, equity shareholders may be paid dividend at the discretion of the Board of Directors. In the same way, the equity shareholders are repaid after all external dues have been paid off in the event of liquidation of the company.
3.	Tax benefit	Interest on debt is a tax deductible expenditure.	Dividend to equity shareholders is paid after payment of tax and the company does not get any tax benefit.
4.	Voting right	They are lenders to the company and do not have voting rights.	They are the owners of the company and enjoy voting rights.

Cost of Capital

The cost of a source of finance is the minimum return expected by its suppliers. The expected return depends on the degree of risk assumed. A high degree of risk is assumed by shareholders than debt-holders. Debt-holders get a fixed rate of interest but shareholder’s dividend is not fixed. The loan of debt-holders is returned within a prescribed period, while shareholders can get back their capital only when the company is wound up. This leads one to conclude that debt is a cheaper source of funds than equity. The preference share capital is cheaper than equity capital, but is not as cheap as debt. However, a company should not employ a large amount of debt. Theoretically, a company should have a right mix of debt & equity so that its overall cost of capital is minimum.

Measuring the cost of capital needs a separate treatment. Needless to say, it is desirable to minimize the cost of capital. Hence, cheaper sources should be preferred, other things remaining same.

Weighted average cost of capital (WACC) is defined as the weighted average of the cost of various sources of finance, weight being the book value or market value of each source of finance outstanding. As mentioned earlier, cost of various sources of finance refers to the return expected by the respective investors.

A company may procure long term funds from various sources like equity share capital, preference share capital, debentures, term loan etc. at different costs depending upon the risk perceived by the investors. When all these cost of different forms of long term funds are weighted by their relative proportion in the total long term funds, we get the overall composite cost of capital termed as weighted average cost of capital.