CAPITAL STRUCTURE

MEANING

Capital structure means the arrangement of capital from different sources so that the long-term funds needed for the business are raised.

Thus, capital structure refers to the proportions or combinations of equity share capital, preference share capital, debentures, long-term loans, retained earnings and other long-term sources of funds in the total amount of capital which a firm should raise to run its business.

The purpose of capital structure is to provide an overview of the level of the company's risk. As a rule of thumb, the higher the proportion of debt financing a company has, the higher its exposure to risk will be.

Capital structure is commonly known as the debt-to-equity ratio.

DEFINITION

According to Gere Stenberg, 'capital structure of a company refers to the composition or make up of its capitalization and it includes all long term capital resources viz., loans, reserves, shares and bonds'. Keown et al. defined capital structure as, 'balancing the array of funds sources in a proper manner, i.e. in relative magnitude or in proportions'.

In the words of P. Chandra, 'capital structure is essentially concerned with how the firm decides to divide its cash flows into two broad components, a fixed component that is earmarked to meet the obligations toward debt capital and a residual component that belongs to equity shareholders'.

Hence capital structure implies the composition of funds raised from various sources broadly classified as debt and equity. It may be defined as the proportion of debt and equity in the total capital that will remain invested in a business over a long period of time. Capital structure is concerned with the quantitative aspect. A decision about the proportion among these types of securities refers to the capital structure decision of an enterprise

CONCEPT OF CAPITAL STRUCTURE

The relative proportion of various sources of funds used in a business is termed as financial structure. Capital structure is a part of the financial structure and refers to the proportion of the various long-term sources of financing. It is concerned with making the array of the sources of the funds in a proper manner, which is in relative magnitude and proportion.

The capital structure of a company is made up of debt and equity securities that comprise a firm's financing of its assets. It is the permanent financing of a firm represented by long-term debt, preferred stock and net worth. So it relates to the arrangement of capital and excludes short-term borrowings. It denotes some degree of permanency as it excludes short-term sources of financing.

Again, each component of capital structure has a different cost to the firm. In case of companies, it is financed from various sources. In proprietary concerns, usually, the capital employed, is wholly contributed by its owners. In this context, capital refers to the total of funds supplied by both - owners and long-term creditors.

The question arises: What should be the appropriate proportion between owned and debt capital? It depends on the financial policy of individual firms. In one company debt capital may be nil while in another such capital may even be greater than the owned capital. The proportion between the two, usually expressed in terms of a ratio, denotes the capital structure of a company.

Example of Capital Structure

Let's consider two different examples of capital structure:

Company A, for our purposes, has $150,000 in assets and $50,000 in liabilities. This means Company A's equity is $100,000.

The company's capital structure is therefore such that for every 50 cents of debt, the company makes $1 of equity.

This, then, would be an example of a low-leverage, or even low-risk, equity capital-structured company.

Now, take its cross-town rival, Company B. Company B has $120,000 in assets, $100,000 in debt and therefore $20,000 in equity.

Company B is "highly leveraged." For every $5 of debt, the company has $1 in equity. This means not only the company needs to increase its returns to be able to finance its debt, eventually, but the company also will be viewed as a greater risk to future lenders.