

# INTRODUCTION

Capital is the major part of all kinds of business activities, which are decided by the size, and nature of the business concern. Capital may be raised with the help of various sources. If the company maintains proper and adequate level of capital, it will earn high profit and they can provide more dividends to its shareholders.

## Meaning of Capital Structure

Capital structure refers to the kinds of securities and the proportionate amounts that make up capitalization. It is the mix of different sources of long-term sources such as equity shares, preference shares, debentures, long-term loans and retained earnings.

The term capital structure refers to the relationship between the various long-term source financing such as equity capital, preference share capital and debt capital. Deciding the suitable capital structure is the important decision of the financial management because it is closely related to the value of the firm.

Capital structure is the permanent financing of the company represented primarily by long-term debt and equity.

## Definition of Capital Structure

The following definitions clearly initiate, the meaning and objective of the capital structures.

According to the definition of **Gerestenbeg,** “Capital Structure of a company refers to the composition or make up of its capitalization and it includes all long-term capital resources”.

According to the definition of **James C. Van Horne,** “The mix of a firm’s permanent long-term financing represented by debt, preferred stock, and common stock equity”.

According to the definition of **Presana Chandra,** “The composition of a firm’s financing consists of equity, preference, and debt”.

According to the definition of **R.H. Wessel,** “The long term sources of fund employed in a business enterprise”.

# FINANCIAL STRUCTURE

The term financial structure is different from the capital structure. Financial structure shows the pattern total financing. It measures the extent to which total funds are available to finance the total assets of the business.

Financial Structure = Total liabilities

Or

Financial Structure = Capital Structure + Current liabilities.

The following points indicate the difference between the financial structure and capital structure.

|  |  |
| --- | --- |
| **Financial Structures** | **Capital Structures** |
| 1. It includes both long-term and short-term sources of funds 2. It means the entire liabilities side of the balance sheet. 3. Financial structures consist of all sources of capital. 4. It will not be more important while determining the value of the firm. | 1. It includes only the long-term sources of funds. 2. It means only the long-term liabilities of the company. 3. It consist of equity, preference and retained earning capital. 4. It is one of the major determinations of the value of the firm. |

### *Example*

From the following information, calculate the capitalization, capital structure and financial structures.

***Balance Sheet***

|  |  |
| --- | --- |
| **Liabilities** | **Assets** |
| Equity share capital 50,000  Preference share capital 5,000  Debentures 6,000  Retained earnings 4,000  Bills payable 2,000  Creditors 3,000 | Fixed assets 25,000  Good will 10,000  Stock 15,000  Bills receivable 5,000  Debtors 5,000  Cash and bank 10,000 |
| 70,000 | 70,000 |

**Calculation of Capitalization**

|  |  |  |
| --- | --- | --- |
| **S. No.** | **Sources** | **Amount** |
| 1. | Equity share capital | 50,000 |
| 2. | Preference share capital | 5,000 |
| 3. | Debentures | 6,000 |
|  | **Capitalization** | **61,000** |

1. **Calculation of Capital Structures**

|  |  |  |  |
| --- | --- | --- | --- |
| **S. No.** | **Sources** | **Amount** | **Proportion** |
| 1.  2. | Equity share capital Preference share capital | 50,000  5,000 | 76.92  7.69 |
| 3. | Debentures | 6,000 | 9.23 |
| 4. | Retained earnings | 4,000 | 6.16 |
|  |  | **65,000** | **100%** |

1. **Calculation of Financial Structure**

|  |  |  |  |
| --- | --- | --- | --- |
| **S. No.** | **Sources** | **Amount** | **Proportion** |
| 1. | Equity share capital | 50,000 | 71.42 |
| 2. | Preference share capital | 5,000 | 7.14 |
| 3. | Debentures | 6,000 | 8.58 |
| 4 . | Retained earnings | 4,000 | 5.72 |
| 5. | Bills payable | 2,000 | 2.85 |
| 6. | Creditors | 3,000 | 4.29 |
|  |  | **70,000** | **100%** |

# OPTIMUM CAPITAL STRUCTURE

Optimum capital structure is the capital structure at which the weighted average cost of capital is minimum and thereby the value of the firm is maximum.

Optimum capital structure may be defined as the capital structure or combination of debt and equity, that leads to the maximum value of the firm.

## Objectives of Capital Structure

Decision of capital structure aims at the following two important objectives:

1. Maximize the value of the firm.
2. Minimize the overall cost of capital.

## Forms of Capital Structure

Capital structure pattern varies from company to company and the availability of finance. Normally the following forms of capital structure are popular in practice.

* + Equity shares only.
  + Equity and preference shares only.
  + Equity and Debentures only.
  + Equity shares, preference shares and debentures.

# FACTORS DETERMINING CAPITAL STRUCTURE

The following factors are considered while deciding the capital structure of the firm.

## Leverage

It is the basic and important factor, which affect the capital structure. It uses the fixed cost financing such as debt, equity and preference share capital. It is closely related to the overall cost of capital.

## Cost of Capital

Cost of capital constitutes the major part for deciding the capital structure of a firm. Normally long- term finance such as equity and debt consist of fixed cost while mobilization. When the cost of capital increases, value of the firm will also decrease. Hence the firm must take careful steps to reduce the cost of capital.

* 1. **Nature of the business:** Use of fixed interest/dividend bearing finance depends upon the nature of the business. If the business consists of long period of operation, it will apply for equity than debt, and it will reduce the cost of capital.
  2. **Size of the company:** It also affects the capital structure of a firm. If the firm belongs to large scale, it can manage the financial requirements with the help of internal sources. But if it is small size, they will go for external finance. It consists of high cost of capital.
  3. **Legal requirements:** Legal requirements are also one of the considerations while dividing the capital structure of a firm. For example, banking companies are restricted to raise funds from some sources.
  4. **Requirement of investors:** In order to collect funds from different type of investors, it will be appropriate for the companies to issue different sources of securities.

## Government policy

Promoter contribution is fixed by the company Act. It restricts to mobilize large, long- term funds from external sources. Hence the company must consider government policy regarding the capital structure.