

E - Content prepared by Shashank Bhushan Lall, Professor,
Varanasi Mahavidyalaya, Patna University, Patna, for students
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Subject : Financial Management
Topic : Capital structure.

Dear students,

We all know that, Financial Management plays a very important role for any business organisation, specially the joint stock companies (J.S. Cos). All of us are aware that company is an artificial person created by law and most suitable form of business organisation, which requires huge capital and professional managerial ability to run the business successfully. The high cost of capital and management can not be borne by other form of business organisation except ~~capital~~ company form of organisation. This is the reason that every company ~~compulsorily~~ go for financial planning, which includes ~~(compulsorily)~~ capitalisation and capital structure as most important tool of planning. Where capitalisation decides the requirement of capital, the structure decides the composition of capital.

Capital structure

A strong capital structure plays a very important role in future success of a business organisation. Every company can not have same capital structure, because the nature of business, its requirements & future needs decides the capital structure of the business.

So, the term capital structure may be defined as, means of arranging capital from various sources, in order to meet the need of long term funds for the business. It is the combination of shares, debentures, bonds, long term loans as well as retained earnings of the business.

As we know that shareholders are the real owner of the companies, it is necessary to keep their interest in mind while forming the capital structure of any company. Apart from this cost of capital is also very important factor.

So through capital structure financial planner of large scale business tries to make a balance between owners fund and creditors fund. A capital mix offering the guarantee of optimum returns and ensuring the protection of owners interest is said to be optimum capital structure.

Essentials of optimum Capital structure

An optimum Capital structure should have following features: -

- 1) Simplicity, 2) Flexibility, 3) Minimum cost, 4) Maximum return
- 5) minimisation of risk 6) Maximum control, 7) liquidity,
- 8) Legal requirements, 9) full utilisation.

Thus, Capital structure is extremely important and Capital structure decisions or practices have a significant role to play in corporate financial management.

Since, the Capital structure decisions impact the risk and return of equity owners, due to which the management needs to take an informed decision of having a perfect Capital mix. A balanced Capital structure is important for the overall health of the company. Excessive use of any component in the Capital mix might not work in favour of the company. An ideal Capital structure helps the company to -

- i) Minimise the cost of Capital
- ii) Reduces business related risks
- iii) Provides needed flexibility
- iv) provides control to the owners
- v) Maximise the value of the firm.

Factors affecting Capital structure

As we had already discussed that, the success of a business very much depends upon its Capital structure, we will now discuss the factors which ultimately affect the Capital structure of a company. These factors may be classified as internal and external factors.

A) Internal factors includes: -

- 1) Income
- 2) Control
- 3) Risk
- 4) Cost of Capital
- 5) Nature of Business
- 6) Assets structure
- 7) Flexibility
- 8) Financial policies of Management
- 9) Purpose of finance
- 10) Cash flows
- 11) Growth and stability

B) External factors

- 1) Capital Market Conditions
- 2) Psychology of Investors
- 3) Expenses of Capital Issues
- 4) Current Regulations & Laws
- 5) Size of the Company
- 6) ~~Cost of~~ Taxation policy
- 7) Level of Business Activity
- 8) nature of Industry
- 9) Economic Condition of the Country

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