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CAPITAL STRUCTURE AND ITS IMPACT ON ECONOMY

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ABSTRACT

All business organizations whether it's manufacturing, trading or service, must build some necessary facilities to hold the business. These facilities are created by acquiring fixed assets and current assets. The choice as per acquisition of those assets is thought as investment decision. Once the investment decision is created, there arises a necessity for determining the suitable amount of various sources of finance for fulfilling the investment needs. This decision is understood as capital structure decision. The company capital structure decision may be a major area of study in finance. It affects the well beings of the corporate both within the short run as well as long term. The capital structure decision is vital due to the necessity to maximise returns of the firm and since of the impact, such a choice has on the firm's ability to cater to its competitive environment. Capital structure refers to the combo or proportion of various sources of finance to total capitalization of a firm. It's the proportion existing between various sources of future capital like equity capital, preference capital and debentures raised in a very firm. A firm should select a financing mix which maximizes its value or minimizes its overall cost of capital. A corporation should plan its capital structure on its incorporation and in its subsequent financing decision should be made for accomplishing the identical. Thus, capital structure decision could be a continuous process and should be made as and when a firm requires additional finances. The importance of capital structure lies within the indisputable fact that different sources of capital have different risk return characteristics. Certain sources of capital are more costly but lesser risky whereas others are lesser costlier but more risky. for example equity is the least risky capital from the company's point of view. Because it's to not be returned to the shareholders during the life time of the corporate and it doesn't involve fixed commitment regarding payment of dividends but its most expensive source of capital. However, there's no empirical evidence on the connection of capital structure of corporate firms in India with market price of the firms and various factors influencing capital structure decisions. This article attempts to judge the patterns of capital structure in Indian corporate sector emerging from financial liberalization and capital market reforms. The difficulty is to research capital structure practices of Indian corporate.

KEYWORDS: *Capital Structure, Retained Earnings, Equity, Debt, Financing, Investment, Corporate.*

Introduction

A business may obtain their require capital fund by the difficulty of ownership securities and by issuing of creditor ship securities. Capital structure refers to a combination of a range of future sources of funds and equity shares including reserves and surpluses of an enterprise. In fact, capital structure has its impact on the value of capital, hence, influences earnings of the firm, investments decisions, value of a firm, operational efficiency, operating income, earning available to shareholders etc. Some companies don't plan their capital structure and it develops as a results of the financial decisions taken by the financial manager with none formal planning. These companies may proper within the short run, but ultimately they'll face considerable difficulties in raising fund to finance their activities with the unplanned capital structure, these companies may additionally fail to earn wise the employment of their funds. Consequently it's being increasingly realized that an organization should plan its capital structure to

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maximise the employment of the funds and to be ready to adapt more easily to the changing conditions. In fact, capital structure has its impact on the price of capital, hence, influences earnings of the firm, investments decisions, value of a firm, operational efficiency, operating income, earning available to shareholders etc. Capital structure refers to a combination of a range of long run sources of funds and equity shares including reserves and surpluses of an enterprise. It hardly takes in its structure, all the complex quantitative factors moreover as qualitative attributes affecting investment decisions.

Capital and Capital Structure

Financial capital can refer to money employed by entrepreneurs and businesses to buy what they have to create their products or provide their services or other sector of the economy supported its operation that is, retail, corporate, investment banking, etc. Financial capital or simply capital in finance and accounting refers to the funds provided by lenders (and investors) to businesses to get real capital equipment for producing goods/services. Financial capital generally refers to saved-up financial wealth especially that accustomed start or maintain a business. Debt comes within the sort of bond issues or long-term notes payable, while equity is assessed as ordinary shares, preferred shares or retained earnings. Short-term debt like capital requirements is additionally considered to be a part of the capital structure. The term capital structure refers to the age of capital (money) at add a business by type. Broadly, there are two varieties of capital which is owned capital and debt capital. Each has its own benefits and downsides and a considerable a part of wise corporate stewardship and management is attempting to seek out the right capital structure in terms of risk / reward payoff for shareholders. This is true for fortune 500 companies and for little business owners trying to work out what quantity of their startup money should come from a loan without endangering the business. Owned capital: This refers to money put up and owned by the shareholders (owners). Typically, owned capital consists of two types, which is contributed capital, which is the money that was originally invested within the business in exchange for shares i.e. preference and equity or ownership and retained earnings, which represents profits from past years that are kept by the corporate and accustomed strengthen the record or fund growth, acquisitions, or expansion.

Factors Affecting Capital Structure Decisions

Capital structure planning is incredibly significant task to survive the business in long term. The term capital structure refers to the connection between the varied long terms kinds of financing like, debenture, preference share capital and equity share capital. Financing the firm's assets may be a very crucial problem in every business and as a general rule there should be a correct mixture of debt and equity capital in financing the firm's assets. the utilization of long –term fixed interest bearing debt and preference share capital together with equity share is termed financial leverage or trading on equity. The long run fixed interest bearing debt is used by firm to earn more from the employment of sources then their cost so on increase the return on owner's equity. It's true that capital structure cannot effect the entire earning of a firm but it can affect the share of earnings available for equity shareholders. Finance manager and top level management decide which source of fund or funds should be selected after scrutinizing the factors affecting capital structures. The correct capital structure planning increases the ability of company to face the losses and alter in financial markets. Whenever the funds are needed, the finance manager needs to study the pros and cons of the assorted sources of finance, so on select the foremost advantageous capital structure. Various factors like Risk of an organization, Flexibility, Level of control on credit, Capital Market condition of the corporate, Nature and Size of the corporate, stability of sale of company, investors, tax benefits to be availed by the corporate, capital structure of the opposite companies and etc.

Optimum Capital Structure

The capital structure is claimed to be optimum when the marginal real cost (explicit also as implicit) of every available source of financing is identical. With an optimum debt and equity mix, the value of capital is minimum and also the value per share (or the overall value of the firm) is maximum. The determination of optimum capital structure is difficult task for every company. The determination of tangible proportion of debt and equity which minimize the general cost of capital is simply impossible. However, approximate amount of debt is ascertained to maximise the shareholders wealth. Miller (1977) has argued that there's an optimal debt-equity ratio for the economy as an entire, no single firm can benefit by varying its own debt equity ratio. There are significant variations among different industries, thus, a hard and fast proportion of debt-equity cannot serve the aim of varying needs of all industries. Different firms falling under one industry may have much in common regarding their plan, but they still may exhibit different earning trends, accounting methods and practices, general future conditions and predictions about the economy and capital market. The factors affecting capital structure varies widely in step with the conditions within the economy, the industry and also the company itself. Above all, the liberty of management to regulate the combination of debt and equity in accordance with these criterion is proscribed by the supply of the varied kinds of debt to possess an appropriate capital structure but the debt might not be available to the corporate because the suppliers of funds might imagine that it'll involve an excessive amount of financial risk for them. Therefore, variety of quantitative and qualitative factors including subjective judgement of economic managers should be considered for designing optimum capital structure in a very given situation. Capital structure should be designed in such how that the interest of equity shareholders, the final word owners, should be the most concern, however, the interest of other interested groups like government, management, employees, suppliers, customers, etc. should be due weightage.

Impact of Capital Structure on Cost of Capital

The general cost of capital has been a well-known issue in finance, yet little is assumed about the cost of capital. The cost of capital is mostly characterized as rate of return which a corporation must procure on its interest keeping in mind the tip goal to satisfy the desires for speculators who give long run subsidizes to that. The principle utilization of cost of capital is within the region of capital planning choice. A choice whether to place resources into a particular undertaking or not relies upon the cost of capital which is thought as cut-off rate. The knowledge about the cost of capital and the way it's suffering from monetary use is useful in planning the capital structure. The connection between capital structure and firm value has been the topic of in depth discussion, both hypothetically and in experimental research. In their original article, Modigliani and Miller exhibit that, in an exceedingly frictionless world, money related use is random to firm value yet in a very world with deductible premium installments, firm value and capital structure are emphatically related. Ideal obligation utilization happens on an outsized scale level, yet it doesn't exist at the firm level. With the nearness of corporate expense shield substitutes for obligation (e.g., devaluation, consumption, amortization and speculation charge credits), each firm will have one of form inside ideal use choice with or without use related expenses. The overall cost of capital may, obviously, be influenced by the capital structure of the firm. In an impeccable, frictionless, tax exempt condition, the division of the web operating profit amongst value and obligation ought to not influence to feature up to value. This theory remains constant in a very given business risk classification. With regards to the insignificance of assembling during a general equilibrium framework, tax isn't a critical consider the peace of mind of a company's capital structure. Subsequently, it's been typically felt that the price of capital and estimation of firm have a converse relationship. The price of capital decays or the estimation of the firm ascents with assign to an adequate snapping point. this concept depends on customary conviction that after expense cost of obligation is a smaller amount expensive than cost of value. Hence, by utilizing obligation in capital structure generally cost of capital is lessened to a base. To accomplish the target of the investigation with relevance the effect of capital structure on the final cost of capital, the cost of capital is split into segment costs for value and obligation.

Conclusion

Capital structure is taken into account collectively of the foremost crucial decision of finance. The business organizations must create facilities for carrying on its operations. These facilities are created by acquiring fixed assets and current assets. The choice regarding acquisition of those assets is understood as investment decision. Once the investment decision is formed, there arises a necessity for determining the suitable mixture of different securities to finance the investment needs. This decision is understood as capital structure decision. Interest payments can generally be deducted from taxable profits while such a deduction isn't available within the case of equity financing. Though leverage cannot change the entire expected earning of the corporate but it can maximize the earnings available to equity shareholders. The firm can choose a combination of financing options to finance its assets so its overall value may be maximized. According to profit approach, a firm can minimize the weighted monetary value of capital and increase the worth of the firm as well as value of equity shares by using debt financing to the utmost possible extent, whereas the net Operating Income approach is entirely opposite to the net Income approach. In keeping with this approach, change within the capital structure of an organization doesn't affect the value of the firm and therefore the overall cost of capital remains constant no matter the method of financing. Thus, there's nothing as an optimal capital structure.

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