

## A STUDY ON THE DETERMINANTS OF CAPITAL STRUCTURE: AN OVERVIEW

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### ABSTRACT

*Capital Structure means how the assets are financed in an organization. Capital Structure is a component of the financial structure and it is in different Proportions of the various long terms sources of finance. Capital structure decision is that decision area where the decision regarding sources of long term procurement of funds is taken. Long term funds are also known as capital in financial management which can be broadly categorized into owned capital and borrowed capital. It is related with making the formalize of the sources of funds in a proper way which is in relative magnitude and proportion, various determinants need to be considered before a decision about a particular capital structure is taken.*

**KEYWORDS:** *Capital Structure, Financial Management, Long Term Funds, Financial Structure.*

### Introduction

Until now, capital structure plays an vital role in any type of organization. Capital structure is a way by which firm can use many sources of funds to finance its assets. Identification the proportion of sources of funds such as debt and equity in organization's performance is considerably. Capital structure is sourced from the two prominent theories: Trade-off theory and Pecking order theory, studying the factors that affect to capital structure behavior and investigating between the company's performance and capital choice. Thus financing decision is all about deciding the composition of overall long term required i.e. the relative mixture of these four sources of long terms funds which is also called as capital mix or capital structure. Capital structure decision is a important decision in financial Management. The decision in a private sector is referred towards the realization of maximization of the shareholders' wealth or value of an organization. The value of an organization relies on anticipated earnings and cost of capital. Capital structure affects the value of an organization by operating on either anticipated earnings or the cost of capital. Due to tax deduction of interest payments, resort to debt financing normally decrease the company's tax liability, but rises the financial risk. Therefore, the management has to select the pattern of capital structure in which the degree of debt minimizes the cost of capital, maximizes earnings available to shareholders and thus maximizes the total value of an organization. Hence, there is a relation between capital structure and cost of capital. This relation has been analyzed by many researchers and theorists. Theories emerged out of such examination related to private sector enterprises. The purpose of this is to study the nature and extent of relationship between two constraints and the elements which affect the relationship in selected firms. We also explore whether the private organization based capital structure theories are relevant to firms or not.

### Theoretical Background

Capital plays a vital and crucial role for organization Performance. Debt and equity are two main components of capital resources. Equity occurs when firms sell some of its ownership right to investors to get more funds support for running the organization. Debts have contractual as well as statutory obligating between companies and credits, and lenders who will receive not only capital but also interest for a predetermined time period. On the theoretical aspects there are two popular theories: Trade-off theory and pecking order theory.

- **Trade-off Theory**

According to trade-off theory, firm should maintain balance how much equity finance and how much debt finance to use by balancing the cost and benefits. Firms in trade-off theory prefix the target debt to value ratio and gradually acquire the target.

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- **Pecking Order Theory**

According to pecking order theory, internal source of firm is given more preference or in case external sources are demanded for financing company's performance, debt is preferred before equity. Therefore the order of financial sources is ranked as retained earnings, debt and equity.

**Determinants of Capital Structure**

- **Financial Leverage or Trading on Equity**

The use of equity share capital along with fixed interest bearing debt and preference share capital is called trading on equity. Financial leverage affects the shareholders return on EPS.

- **Cost of Capital**

Cost is the chief determinant but not the sole determinant of capital structure. Cost is the significant factor in deciding the capital structure. The cost of different sources of finance is different because of their different risk characteristic (Statutory obligation and contractual obligation).

- **Risk**

There are two types of risk that are recognized while projecting the capital structure of firm i.e. business risk and financial risk. Business risk means the variability to net operating income.

- **Nature and Size of a Firm**

Nature and size of a firm also affects its capital structure. The size of company affects the availability of funds from different sources. A big company easily raises long term loans in compare to small company.

- **Floatation Cost**

Floatation costs are aroused when the funds are raised. Normally, the cost of floating a debt is less than that of an equity issue. This may stimulate a company to use debt rather than issue equity shares.

- **Stability of Sales**

The Capital Structure of a firm is highly affected by growth and stability of its sales. The rate of progress in sales also affects the capital structure decision.

**Sources of Finance**

- **Debt**

It includes all kinds of borrowed capital like debentures, bonds, loans etc.

- **Equity**

Capital comprising of ordinary shares or equity share of the company which carry no preferential right regarding payment of dividend and repayment of capital at the time of liquidation of the company.

- **Preference Capital**

Capital comprising of shares which carry preferential rights regarding dividend payment as well as repayment of capital either at time of maturity or at the time of liquidation.

- **Retained Earning**

Accumulated earning which has not been distributed with the shareholders as dividend and can be ploughed back into the business as a long term source of finance.

**Cost of Capital**

As mentioned above cost is the prime determinate but not the exclusive determinant of pattern of capital structure. In other words, cost is the important factor in deciding the capital structure. The cost of various sources of finance is different because of their various risk characteristic (statutory obligation and contractual obligation). Therefore overall cost of capital is found out represented by  $k_0$  which is actually weighted average cost of capital where each specific cost is assigned a rate which is the respective proportion of each specific source of financing in the overall expenditure/ capitalization. The specific costs of each of the four source of long term financing are depicted by  $k_d$ ,  $k_p$ ,  $k_e$  and  $k_r$ . conceptually the cost of any specific source of long term financing is determined by the relationship between the inflow from the source of financing at  $T_0$  and the outflows associated with that source of finance in  $T_n$  (later years). Thus it can be seen that "computation and analysis in cost of capital decisions or financing decisions is exactly the reverse of capital budgeting decisions."

- **Cost of Debt**

Debt is considered as cheapest source of finance in financial management as far as long term financing is concerned. This is because interest on debt as well as repayment of debt or redemption of debt is a contractual as well as statutory obligation on the part of the company. Thus the risk of the debt provider

is the least and the interest on debt carries the same right as of debt i.e. if debt is a secured capital then interest on debt is also a secured capital. However debt can be redeemable as well as irredeemable and the cost computation in both the cases is different. It can be seen from the above that even cost of debt is nothing but the rate at which the outflows (i.e. interest net of tax) are discounted would give the value of all the outflows equal to the inflows at  $T_0$ . It can be seen that  $k_i = k_d$ , only when no parameter i.e. tax, discount, premium, floatation cost is present. It means that whenever any one or more of these parameters would be present,  $k_i = k_d$  and here the two parameters i.e. tax and discount where present. Whenever there is periodic redemption, cost of debt cannot be computed with the shortcut method used in case of one time redemption. This is because annual outflows are not in annuity form or uniform. This happens because along with the interest part, principal part is also paid every year. Therefore outflows of every year would be different and going by the same logic that cost of any security is the discounting rate at which present value of all the outflows would be equal to present value of inflows at  $T_0$ . Thus  $k_d$  would be computed just like the way IRR is computed.

- **Cost of Preference Capital**

Computation of cost of preference capital by and large follows the same logic & same procedure as the computation of cost of debt. Even preference capital like debt capital carries a coupon rate which determines the annual servicing burden for the company in the form of dividend. Thus computation wise everything remains the same except the fact that there is no tax shield in case of preference dividend. Thus cost of preference capital of redeemable as well as irredeemable preference capital (if law of land permits) can be computed. In India, a company cannot issue irredeemable preference share i.e. it can issue only redeemable preference share with the maximum redemption time of 20 years. It needs to be noted that difference in the above formulas is only of interest & dividend where there is tax advantage in case of preference dividends. To elaborate, in case of 10% debenture of Rs. 100 (tax rate 40%) the outflow for the company is Rs. 6 whereas in case of 10% preference share of Rs. 100 each, the outflow would be Rs. 10 only rather it can be more than Rs. 10 if dividend distribution tax is levied on the company. This is because in that cost outflow of company would increase i.e. if 20% is dividend distribution tax, the outflow of company would be  $10(1+0.2)$  i.e. Rs. 12. As already discussed the cost of any source of capital is discounting rate at which present value of all the future outflows is equal to present value of annual inflow  $T_0$ . In case of debt, outflows are certain & uniform every year and if not uniform then it is certain every year (in case of redeemable debt & not happen in case of irredeemable debt). Therefore, there is no problem in computation of  $k_d$  because interest payment cannot be skipped in any year as it is charged against profit and can be paid even out of capital, in case of insufficient profit. Thus as far as servicing burden is concerned, in case of debt, it carries contractual as well as statutory obligations on the part of the company or of the firm.

In this context, it needs to be noted that:

- Contractual obligation is the obligation of the company which arises out of the contract between the fund provider & the company which is determined by coupon rate.
- Statutory obligation which arises out of the law prevailing i.e. company act.
- However in case of preference capital annual servicing burden is not certain though it can be uniform or not uniform. This is because dividend of preference capital though it carries a coupon rate & preference share holders have a preferential right to receive dividend prior to equity shareholders, they do not enjoy same degree of protection as enjoyed by debenture holders. To elaborate, if the preference shares are non cumulative, then obligation to pay dividend at specified coupon rate is not a statutory obligation to pay dividend every year. In other words, if preference share are non cumulative & if there are zero or inadequate profits, then the preference dividend may be skipped and may not even accumulate to be discharged later on. However, if preference shares are cumulative, then certainty attached with the payment of preference dividend is better than certainty in non cumulative preference shares but still it is not of same degree as of debentures or debt. Thus in case of non cumulative preference shares, the dividend is not paid in bad years would not accumulate to pay later on. Moreover, preference dividend is not a charge against profit and cannot be paid out of capital.

- **Cost of Equity Capital**

Equity shares are described as ordinary shares because they do not have any preferential right neither at the time of servicing nor at time of repayment of capital i.e. dividend on equity share if at all is paid after paying the preference dividend. Similarly repayment of equity capital if at all is made at time of

liquidation is made after redemption of preference share capital. Further equity capital does not carry any coupon rate of dividend and thus it is not even a contractual obligation regarding dividend payment let alone the statutory obligation. Thus there are no certain & uniform annual outflows in the form of equity dividend and since equity is a perpetual capital, there is no outflow in times of redemption as well. Thus by the above discussion, it appears that "equity is a cost free source of financing" or "cheapest source of financing". However, it can be seen that all these factors increases the risk perception of equity shareholders. As a result, their expectations for return increases which leads to increase in cost of equity to the company. Thus, since the equity shareholders take the highest risk, they have highest expectations for return leading to highest cost of capital to the company. This is based on cardinal principle & financial management coming out of "Risk-Return trade off" i.e. higher risk is taken only for higher expectations for return. In other words, equity shares are that category of fund suppliers who takes maximum risk because they are supplying perpetual funds i.e. there is no maturity period & repayment of principal is also not guaranteed. Not only there is no maturity period but also at time of liquidation, their claim is of vast priority i.e. they get after paying everybody else.

Thus, as a result any rational investor taking so much of risk would expect a higher rate of return and this risk return trade off analysis makes the equity cost least source of finance and gives the order. In face it is costlier than retained earnings because of the transaction cost that may be there in case of raising capital through equity.

- **Cost of Retained Earnings**

Conceptually cost of retained earnings is same as cost of equity capital because when a company makes use of retained earnings for its long term financing, it is actually making use of equity shareholders money lying with company because they are those part of earnings of shareholders which were not distributed as dividend and was rather retained in the business. Every time equity shareholders are derived dividend for actually was their shares of earnings was retained by firm for future investment. It is just like equity shareholders giving that money afresh to the company. Thus retained earnings are shareholders money reinvested in the company and like any rational investor; they would expect the return on the same. Therefore it may appear that retained earnings are cost free source of financing but actually they do have the cost & in fact they have the same cost as of equity because shareholders keep an eye on these retained earnings and expect return on that as well. Retained earnings are beneficial for company as well as investor if investible opportunities are available with the company. This is because company would get a hassle free financing without any statutory or procedural formalities.

### **Conclusion**

Consequently, Capital structure was presumed through the short terms debt ratio is positively affected by structure of assets. This study presented the net profit and EPS have the same level impact on long term debt rate as well as short terms debt rate. The other elements have different level impacts on long term debt ratio when we compare the degree impact with short term debt ratio.

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