Capital Structure
(Financial Management)

Dr. Nagesh Parashar

School of Studies in Commerce

Vikram University, Ujjain

Meaning of Capital Structure

Capital Structure is the ratio of different kinds of securities hold by a firm as long-term finance.

Definitions:

* A firm's *capital structure is the composition/ structure of its liabilities.*

Definitions…

*The *capital structure is how a business unit finances its overall activities and growth by using different sources of funds.*

* *Capital Structure is the amount of debt and/or equity employed by a firm to fund its business activities and finance its assets*

Capital Structure Decisions

The capital structure involves two decisions-

a. Different Types of securities to be issued are equity shares, preference shares and long term debts (Debentures).

b. Relative ratio of securities can be calculated by method of capital gearing. With this basis, the companies are divided into two-

i. Highly geared companies - Those companies in which equity capitalization is small.

ii. Low geared companies - Those companies in which equity capitalization is dominated.

Factors Determining Capital Structure

1. **Trading on Equity-** **The word "equity" related to the ownership of the company. Trading on equity means taking gain of equity share capital to borrowed funds. It refers to additional gains that equity shareholders earn because of issuance of debentures and preference shares.**

2. **<u>Degree of control- </u>In a company, directors are elected representatives of equity shareholders. These members have got majority voting rights in a concern in comparison to the preference shareholders and debenture holders. Preference shareholders have less voting rights though debenture holders have no voting rights. If the management wants to retain their voting rights in their hands, the capital structure will have debenture holders and loans rather than equity shares.**

3. **Flexibility of financial plan-** In a business unit, the capital structure should be flexible. Debentures and loans may be returned back as the time requires. While equity capital cannot be returned at any time which provides rigidity . Therefore, in order to make the capital structure suitable the company should go for issuance of debentures and other loans.

4. Choice of investors- **A capital structure should give sufficient choice to differerent kind of investors to invest. Young, Bold and courageous investors generally go for equity shares and loans and debentures are generally raised for conscious investors.**

5. Capital Market Conditions- In the lifespan of the company, the market price of the shares has got a prominent influence. In the depression period, the company's capital structure generally consists of debentures and loans. While in times of boons and inflation, the company's capital should consist of share capital generally equity shares.

Thank You