
UNIT 11 CAPITAL STRUCTURE

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11.1 INTRODUCTION

Capital structure refers to the mix of different types of financing used by a company to fund its operations and growth. The different sources of financing include debt, equity, and hybrid securities such as convertible bonds. The goal of a company's capital structure is to achieve an optimal mix of financing that minimizes the cost of capital and maximizes shareholder value.

A company's capital structure decision is influenced by several factors, including its financial strength, industry conditions, growth prospects, regulatory environment, and management preferences. The use of debt or equity financing affects the company's risk profile, cost of capital, and financial flexibility.

The optimal capital structure for a company depends on its specific circumstances and goals. For example, a mature company with stable cash flows and low growth prospects may prefer a debt-heavy capital structure to take advantage of tax shields and lower the cost of capital. On the other hand, a growth-oriented company with volatile cash flows and higher risk may prefer an equity-heavy capital structure to reduce financial risk.

The theories of capital structure provide different perspectives on how companies should decide on their optimal capital structure. These include the net income approach, net operating income approach, traditional approach, and the Modigliani and Miller approach. The pecking order theory suggests that companies prefer internal financing, followed by debt financing and finally equity financing, due to the varying costs of capital and information asymmetries.

11.2 OBJECTIVES

After reading this unit you will be able to understand:

- Capital Structure.
- Difference between Capital Structure and Financial Structure
- Factors Affecting Capital Structure.
- Theories of Capital Structure.

11.3 CAPITAL STRUCTURE

Capital structure refers to the mix of debt and equity financing used by a company to fund its operations and investments. The capital structure of a company determines its overall financial risk, cost of capital, and financial flexibility.

Debt financing involves borrowing money from lenders such as banks, bondholders, or other financial institutions, which is then repaid with interest. Equity financing involves raising capital by selling shares of ownership in the company to investors, who then become shareholders and participate in the company's profits and losses.

The optimal capital structure for a company depends on several factors, including its industry, size, growth prospects, and risk profile. A company with stable cash flows and low financial risk may prefer a higher level of debt financing to take advantage of the tax benefits associated with interest payments. However, a company with volatile cash flows and high financial risk may prefer a lower level of debt financing to avoid the risk of default.

The capital structure of a company affects its cost of capital, which is the weighted average cost of debt and equity financing used by the company. The cost of capital determines the minimum rate of return required by investors to invest in the company's projects or operations. A higher level of debt financing can lower the cost of capital due to the tax benefits of interest payments, while a higher level of equity financing can increase the cost of capital due to the higher expected rate of return demanded by shareholders.

Thus, capital structure is the mix of debt and equity financing used by a company to fund its operations and investments, and it plays a crucial role in determining the company's overall financial risk, cost of capital, and financial flexibility.

11.4 CONCEPT OF CAPITAL STRUCTURE

Capital structure refers to the way a company finances its operations and growth by using a mix of debt and equity financing. It is the combination of long-term debt, preferred stock, and common equity that a company uses to finance its operations and growth.

Debt financing is the process of borrowing money, which is repaid with interest over a set period. This includes bank loans, bonds, and other debt instruments. Equity financing involves selling ownership in the company through the issuance of common or preferred shares, which represent a claim on the company's assets and earnings.

The optimal capital structure for a company depends on a number of factors, including the industry, size, growth prospects, and risk profile of the company. Companies in stable industries with predictable cash flows may prefer to use more debt financing to take advantage of tax benefits and reduce the cost of capital. On the other hand, companies in volatile industries may prefer to use more equity financing to avoid the risk of default and bankruptcy.

Capital structure decisions also affect a company's cost of capital, which is the minimum return that investors expect from the company to compensate them for the risk of investing. A company's cost of capital is a weighted average of the cost of debt and equity financing. A higher proportion of debt financing may lower the cost of capital due to the tax benefits of interest payments, while a higher proportion of equity financing may increase the cost of capital due to the higher expected rate of return demanded by shareholders.

Capital structure refers to the composition of a company's capital, which includes both *equity and debt*.

Equity refers to the ownership interest in a company or property. It represents the residual value of assets minus liabilities and is often used to measure the net worth of a business. In a company, equity represents the amount of assets that remain after all the liabilities have been paid off. Equity can be raised through the sale of stock, either publicly or privately. Equity investors have an ownership stake in the company and are entitled to a share of its profits, usually in the form of dividends or capital gains.

Debt refers to money that is borrowed and must be repaid, typically with interest. In the context of a business, debt can be obtained through loans, bonds, or other forms of credit. Unlike equity, debt does not represent ownership in the company, but rather a contractual obligation to repay the borrowed funds at a specified time with interest. Debt financing can be secured or unsecured, depending on whether or not it is backed by collateral, such as property or equipment. While debt can be a useful tool for financing a company's growth and

operations, it also carries risk, as failure to make timely payments can result in default, which can have serious consequences for the company's financial health.

Equity represents the ownership interest in the company, while debt represents the money borrowed by the company. Equity further include the following components:

- a) **Equity Share Capital:** This represents the amount of money raised by the company through the sale of common shares. Shareholders who own these shares are entitled to vote on corporate matters and receive a portion of the company's profits in the form of dividends.
- b) **Preference Share Capital:** This represents the amount of money raised by the company through the sale of preferred shares. Unlike common shares, preferred shares have a fixed dividend rate and often have priority over common shares in the payment of dividends and distribution of assets in the event of liquidation.
- c) **Share Premium:** This represents the amount of money raised by the company when shares are issued at a price higher than their face value. Share premiums are added to the share capital and reflect the amount of money that investors are willing to pay for the company's shares.
- d) **Reserves and Surplus:** This represents the accumulated profits of the company that have not been distributed as dividends. The company may choose to retain these earnings for reinvestment in the business or distribute them as dividends to shareholders in the future. Reserves and surplus may also include various reserves created out of profits, such as general reserve, capital reserve, and revenue reserve.
- e) **Retained Earnings:** This represents the portion of the company's profits that have been retained and reinvested in the business. Retained earnings can be used to fund future growth initiatives, repay debt, or distribute as dividends to shareholders.
- f) **Provisions for Contingency:** This represents the amount of money set aside by the company to cover unforeseen events or potential losses. These provisions reduce the company's profits and the amount available for distribution as dividends to shareholders.

Debt represents the borrowed funds that a company uses to finance its operations and growth. Debt comprises of the following:

- a) **Debentures:** As mentioned earlier, debentures are long-term debt instruments issued by a company to raise funds. They are typically unsecured, meaning there is no collateral provided to back them up. Instead, debentures are backed by the creditworthiness of the issuer. Debentures usually carry a fixed rate of interest and a specific maturity date. They may be redeemable or non-redeemable, and convertible or non-convertible.

- b) **Long-Term Loans from Banks and other Financial Institutions:** These are loans that a company obtains from banks or other financial institutions to finance its operations or capital expenditures. Long-term loans usually have a maturity of over one year and require the borrower to make regular interest and principal payments. The interest rate on these loans is generally fixed or variable and is based on the prevailing market rates at the time of borrowing.
- c) **Long-Term Borrowings:** This category includes any long-term liabilities that a company may have, such as bonds or notes payable. Bonds are typically issued by larger companies and governments and are backed by the issuer's creditworthiness. Bonds may be secured or unsecured, and they can be callable or non-callable. Notes payable are similar to bonds but are typically issued by smaller companies or individuals and have a shorter maturity.
- d) **All Deferred Payment Liabilities:** Deferred payment liabilities are amounts that a company owes for goods or services received, but payment for which is deferred to a later date. These liabilities include items such as deferred taxes, deferred revenue, and deferred income taxes. Deferred taxes arise from timing differences between when taxes are paid and when they are accrued, while deferred revenue is revenue that has been collected but has not yet been earned. Deferred income taxes are taxes that are deferred to future periods due to differences between book and tax accounting methods.

Features of Optimum Capital Structure

The optimum capital structure refers to the combination of debt and equity financing that maximizes the value of the firm and minimizes its overall cost of capital. Here are some features of an optimum capital structure:

- a) **Flexibility:** The capital structure of a company should be flexible enough to adjust to changes in business conditions, such as changes in interest rates or economic downturns. A flexible capital structure allows the company to access different sources of funding and to adjust its debt-to-equity ratio as needed.
- b) **Cost of Capital:** An optimum capital structure minimizes the cost of capital for the company. This means finding the right balance between the cost of debt and the cost of equity financing. Debt financing is generally less expensive than equity financing due to tax benefits, but too much debt can increase the company's risk and cost of borrowing.
- c) **Risk Management:** An optimum capital structure helps to manage the risk of the company. This means balancing the risk of debt financing with the risk of equity financing. Too much debt can increase the risk of default, while too much equity can dilute ownership and control of the company.

- d) **Growth Potential:** An optimum capital structure should allow the company to fund its growth potential. This means finding the right balance between debt and equity financing to ensure that the company has enough capital to fund its operations and invest in new opportunities.
- e) **Shareholder Value:** An optimum capital structure should maximize shareholder value. This means finding the right balance between debt and equity financing to ensure that the company is able to generate profits and distribute them to its shareholders while maintaining its long-term financial health.

11.5 DIFFERENCE BETWEEN CAPITAL STRUCTURE AND FINANCIAL STRUCTURE

The main differences between capital structure and financial structure are as follows:

- a) **Definition:** Capital structure refers to the mix of equity and debt financing that a company uses to fund its operations and growth. Financial structure, on the other hand, refers to the broader set of financial arrangements that a company uses to manage its finances, including capital structure, cash management, and risk management.
- b) **Components:** Capital structure is made up of equity and debt financing. Financial structure includes capital structure as well as other financial components such as working capital management, cash flow management, and risk management.
- c) **Focus:** Capital structure is primarily concerned with the long-term financing of a company. Financial structure, on the other hand, encompasses a wider range of financial activities that a company undertakes to manage its day-to-day finances and mitigate financial risk.
- d) **Flexibility:** Capital structure is generally more fixed and difficult to change than financial structure, which can be adjusted more easily to respond to changing market conditions or business needs.
- e) **Risk:** The use of debt financing in capital structure creates financial risk for a company, as it must make regular interest and principal payments on its debt. Financial structure includes risk management activities that help to mitigate financial risk, such as hedging and insurance.
- f) **Impact on Valuation:** Capital structure decisions can have a significant impact on a company's valuation, as the mix of debt and equity financing affects the cost of capital and the perceived riskiness of the company. Financial structure also affects valuation, but to a lesser degree than capital structure.

11.6 FACTORS AFFECTING CAPITAL STRUCTURE

- a) **Business Risk:** Business risk refers to the variability of earnings before interest and taxes (EBIT) due to factors such as competition, technological changes, economic cycles, and other factors. Companies that operate in industries with high business risk may prefer to use more equity financing to reduce their financial risk. For example, a start-up in the technology industry that has high uncertainty regarding its future cash flows may choose to rely on equity financing.
- b) **Financial Risk:** Financial risk refers to the variability of earnings per share (EPS) due to the use of debt financing. Companies that use a high proportion of debt financing are more exposed to financial risk. A high level of financial risk can lead to the possibility of bankruptcy in case the company is unable to meet its debt obligations. For example, a company that relies heavily on debt financing may have a higher cost of capital due to the higher risk of default.
- c) **Cost of Capital:** The cost of capital is the rate of return that a company must earn on its investments to satisfy its investors. The cost of capital is influenced by factors such as interest rates, inflation, and the risk of the company's operations. Companies that have a lower cost of capital may be able to use more debt financing to take advantage of the tax shield effect of debt.
- d) **Taxation:** Debt financing provides companies with tax advantages due to the interest paid on debt being tax-deductible. Therefore, companies may prefer to use debt financing to reduce their tax burden. For example, a company that has a high tax rate may prefer to use debt financing to reduce its tax liability.
- e) **Flexibility:** Companies may prefer to use equity financing as it provides more flexibility compared to debt financing. Equity financing does not require the company to make fixed payments as is the case with debt financing. This flexibility allows companies to invest in growth opportunities without having to worry about meeting debt obligations.
- f) **Market Conditions:** The availability of debt financing and equity financing is influenced by market conditions such as interest rates, inflation, and the availability of funds. During a recession, companies may find it difficult to obtain debt financing, leading them to rely more on equity financing.
- g) **Industry Norms:** Industry norms also influence the capital structure of a company. For example, some industries, such as utilities, may have a higher proportion of debt financing due to the stable nature of their cash flows. On the other hand, technology companies may have a lower proportion of debt financing due to the higher risk associated with their operations.
- h) **Size of the Company:** Larger companies may have more access to debt financing due to their scale of operations and greater assets. Smaller companies may rely more on equity financing as it is easier for them to raise capital through equity issuances.

- i) **Company's growth prospects:** The growth prospects of a company play a crucial role in determining its capital structure. Companies that are experiencing high growth require a significant amount of capital to finance their expansion plans. They may choose to use more debt in their capital structure to finance their growth plans as it may be cheaper than equity financing. On the other hand, companies that are mature and have stable growth prospects may prefer to use more equity financing in their capital structure as it may be less risky than debt financing.

For example, a start-up company with high growth potential may decide to use debt financing to fund its expansion plans. This would allow the company to conserve its cash resources and use debt to finance its growth plans. In contrast, a mature company with stable growth may decide to use equity financing to fund its expansion plans. This would allow the company to avoid the risks associated with high levels of debt.

- j) **Management preferences:** Management preferences also play a significant role in determining a company's capital structure. The management team of a company may have a preference for either debt or equity financing, depending on their risk appetite, financial goals, and personal biases.

For example, if the management team of a company is risk-averse, they may prefer to use more equity financing in their capital structure to reduce the risk of financial distress. Conversely, if the management team is comfortable taking on more risk, they may prefer to use more debt financing to fund their growth plans.

- k) **Regulatory environment:** The regulatory environment can also affect a company's capital structure decisions. Regulations may limit the amount of debt that a company can take on, or they may require companies to maintain a certain debt-to-equity ratio.

For example, the banking industry is subject to strict regulations that limit the amount of debt that banks can take on. This is because too much debt can make banks vulnerable to financial distress, which can have systemic implications for the economy as a whole. As a result, regulators require banks to maintain a certain debt-to-equity ratio to ensure that they remain financially sound.

11.7 LEGAL REQUIREMENTS REGARDING CAPITAL STRUCTURE

The finance manager while deciding on the capital structure of a company must also consider the legal requirements and regulations that govern the issuance of securities. Some of the important legal requirements regarding capital structure are:

- a) **Company's Articles of Association:** The Articles of Association of a company lay down the rules and regulations regarding the issuance of securities. The finance manager must ensure that the company complies with these rules while issuing securities.

- b) **Companies Act, 2013:** The Companies Act, 2013 provides guidelines and regulations for the issuance of securities by companies. The finance manager must ensure that the company complies with the provisions of the Act while issuing securities.
- c) **Securities and Exchange Board of India (SEBI):** SEBI is the regulatory body that governs the issuance of securities in India. The finance manager must ensure that the company complies with the guidelines and regulations issued by SEBI while issuing securities.
- d) **Reserve Bank of India (RBI):** RBI regulates the borrowing and lending activities of companies in India. The finance manager must ensure that the company complies with the guidelines issued by RBI while borrowing funds.
- e) **Tax Laws:** The tax laws in India have an impact on the cost of capital for a company. The finance manager must consider the tax implications of the different sources of financing while deciding on the capital structure of the company.
- f) **Stock Exchange Listing Requirements:** If a company is listed on a stock exchange, it must comply with the listing requirements of the exchange. The finance manager must ensure that the company complies with these requirements while issuing securities.
- g) **Credit Rating Agencies:** Credit rating agencies provide ratings for the debt instruments issued by companies. The finance manager must ensure that the company maintains a good credit rating in order to borrow funds at lower rates of interest.
- h) **Foreign Exchange Regulations:** If a company raises funds from foreign sources, it must comply with the foreign exchange regulations of the country. The finance manager must ensure that the company complies with these regulations while raising funds from foreign sources.



Check Your Progress-A

Fill in the blanks.

1. is the rate of return that the investment opportunity is expected to generate over its expected life.
2. involve managing the company's investment portfolio, which may include stocks, bonds, and other financial instruments.

11.8 INTRODUCTION TO THE THEORIES OF CAPITAL STRUCTURE

The different theories of capital structure are as follows:

1. Net Income Approach:

The Net Income Approach suggests that the value of a firm is maximized by using more debt in the capital structure. This theory proposes that the use of debt increases the earnings per share (EPS) for the shareholders. It is based on the assumption that the cost of debt is lower than the cost of equity, and the interest paid on debt is tax-deductible. Therefore, increasing the amount of debt in the capital structure reduces the taxable income and ultimately reduces the amount of tax paid.

2. Net Operating Income Approach:

The Net Operating Income Approach, also known as the NOI approach, suggests that the value of a firm is independent of its capital structure. It argues that the value of a firm is determined solely by its ability to generate operating income, and not by the way it is financed. According to this theory, the cost of capital is the same regardless of the amount of debt used, and changing the capital structure has no effect on the value of the firm.

3. The Traditional Approach:

The Traditional Approach is based on the assumption that there is an optimal capital structure that maximizes the value of the firm. It suggests that the cost of capital and the value of the firm are related to the capital structure. The theory proposes that there is an optimum debt-to-equity ratio that minimizes the overall cost of capital, and this ratio depends on the nature of the business and the industry in which it operates.

4. Modigliani and Miller Approach:

The Modigliani and Miller (MM) Approach is based on the assumption that capital markets are perfect and that investors behave rationally. The theory is divided into two parts:

a) Without taxes:

The first part of the MM approach suggests that the value of the firm is independent of its capital structure in a perfect capital market. It argues that the cost of equity is directly proportional to the amount of debt used, and as a result, the overall cost of capital remains constant.

b) With taxes:

The second part of the MM approach considers the effect of taxes on the capital structure. It suggests that the use of debt in the capital structure provides tax shields, which increase the value of the firm. This theory proposes that the optimal capital structure is 100% debt, as it maximizes the tax shields and, therefore, the value of the firm.

Each of these theories has its assumptions and limitations and may not be applicable to all types of firms or industries. Therefore, it is essential for a finance manager to carefully consider these theories and other factors before making decisions regarding the capital structure of a company.

Assumptions of Theories of Capital Structure

1) Net Income Approach:

- a) There are no corporate taxes
- b) There are no bankruptcy costs
- c) There is a fixed business risk
- d) The company does not issue any new shares
- e) Investors have access to same information
- f) There is no difference between dividend and retained earnings

2) Net Operating Income Approach:

- a) There are no taxes
- b) There is no bankruptcy cost
- c) The cost of debt remains constant with changes in leverage
- d) The firm can be valued perpetually

3) Traditional Approach:

- a) There is a corporate tax rate
- b) The company has a permanent operating income
- c) Debt is cheaper than equity
- d) The company's cost of equity increases with leverage

4) Modigliani and Miller Approach:

- a) There are no taxes
- b) There are no transaction costs
- c) There are no bankruptcy costs
- d) There is no information asymmetry
- e) There are no agency costs

- f) There are no personal taxes
- g) Investors have the same borrowing and lending rates

11.9 CAPITAL GEARING

Capital gearing refers to the degree to which a company's long-term funds are financed by equity shares or debt. In other words, it is the proportion of debt and equity in a company's capital structure.

A company that has a high proportion of debt in its capital structure is considered to be highly geared, while a company with a low proportion of debt is considered to be low geared. The level of gearing can have a significant impact on the risk and return of the company.

Companies use capital gearing as a financial strategy to raise funds and optimize their capital structure. The use of debt allows a company to raise additional funds without diluting the ownership of existing shareholders. However, it also increases the risk to the company as the interest on debt has to be paid regardless of the company's profits.

Investors and analysts use capital gearing ratios to evaluate a company's financial risk. The most commonly used gearing ratios are debt-to-equity ratio, debt-to-assets ratio, and interest coverage ratio.

A high level of gearing can make a company more vulnerable to economic downturns and changes in interest rates. On the other hand, a low level of gearing may indicate that the company is not using debt to optimize its capital structure and may not be taking full advantage of the benefits of debt financing.

11.10 PECKING ORDER THEORY

Pecking order theory is a theory of corporate capital structure that suggests that companies prefer to use internal funds first, then debt, and finally equity, in that order. This theory was first proposed by Stewart C. Myers and Nicolas Majluf in 1984.

The pecking order theory is based on the idea that asymmetrical information between managers and investors leads to different costs for raising capital through debt and equity. Internal funds, such as retained earnings, are seen as the cheapest source of financing because there are no transaction costs, no agency costs, and no adverse selection issues.

If a company needs more funds than it can generate internally, it will turn to external financing. Debt is preferred to equity because it has lower transaction costs, less dilution of ownership, and a fixed repayment schedule. However, debt also has a greater risk of bankruptcy and may require the company to make regular interest payments.

Equity is seen as a last resort because of the high costs associated with issuing new shares. Issuing new equity can lead to dilution of ownership and reduced control for existing

shareholders. Therefore, it is only considered when internal funds and debt financing are insufficient.

The pecking order theory suggests that companies prioritize their sources of financing in a hierarchical order as follows:

- 1) **Internal financing:** The first choice for a company is to use its retained earnings and profits to finance its investments and expansion plans. This is because internal financing is considered the least risky and least expensive option for a company.
- 2) **Debt financing:** If a company does not have sufficient internal funds to finance its investments, the next option is to use debt financing. Debt financing includes bank loans, corporate bonds, and other forms of borrowing. Debt financing is considered less expensive than equity financing, but it increases the company's financial risk and the cost of capital.
- 3) **Equity financing:** The last resort for a company is to issue new shares of stock to raise capital. Equity financing is considered the most expensive option for a company since it dilutes the ownership of existing shareholders and also involves higher transaction costs.

The pecking order theory suggests that companies prefer internal financing over external financing, and debt financing over equity financing.



Check Your Progress- B

Write True or False.

3. Net Present Value (NPV) is a discounted cash flow method that compares the present value of cash inflows generated by an investment to the initial investment.
4. The ARR is calculated by dividing the average annual profit of an investment by the initial investment.
5. Terminal Value = (Cash flow in final year x (1+growth rate)) x (Discount rate - growth rate).

11.11 SUMMARY

Capital structure refers to the composition of a company's long-term sources of financing, which includes both equity and debt. The ideal capital structure depends on a variety of factors, including the company's growth prospects, risk appetite, and the regulatory environment.

There are different theories of capital structure, including the net income approach, net operating income approach, the traditional approach, and the Modigliani and Miller approach.

The Pecking Order Theory also suggests that companies prefer to finance their investments using internal sources of funds such as retained earnings, followed by debt, and then equity.

The concept of capital gearing is an important aspect of capital structure, which refers to the proportion of debt and equity in a company's financing mix. A company's capital gearing can influence its risk profile, cost of capital, and financial flexibility.

Legal requirements related to capital structure also exist, including regulations regarding the maximum level of debt that a company can raise and the minimum level of equity that it must maintain.

Thus, selecting an optimal capital structure is important for companies, as it can impact their financial performance, risk profile, and ability to attract funding.

11.12 GLOSSARY



- **Capital Structure:** Capital structure refers to the composition of a company's capital, which is the money it uses to finance its operations and growth. It includes both equity and debt, as well as any other long-term financial obligations. The capital structure of a company can affect its ability to raise capital, its cost of capital, and its financial flexibility. It is a key consideration for companies when making financing decisions.
- **Debt:** Debt refers to the amount of money borrowed by an individual or an organization from a lender, usually with a promise to pay back the borrowed amount along with interest within a specified period. In the context of capital structure, debt refers to the portion of a company's capital that is raised by borrowing funds from various sources such as banks, financial institutions, bondholders, and other lenders, rather than issuing shares or other forms of equity. The repayment of debt typically involves a fixed schedule of payments, including interest and principal, and failure to make timely payments can lead to penalties or default.
- **Equity:** Equity refers to the ownership interest in a company after all the debts and obligations have been paid off. It represents the residual value of the assets of the company and is also known as shareholders' equity or net assets. Equity holders are entitled to a share in the profits of the company, usually in the form of dividends, and have the right to vote in the company's decision-making processes. Equity can be raised through the issuance of equity shares, preference shares, and other instruments that represent ownership in the company.

11.13 ANSWERS TO CHECK YOUR PROGRESS



Check Your Progress –A

1. IRR
2. Portfolio management decisions

Check Your Progress –B

3. True.
4. True.
5. False.

11.14 REFERENCES



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11.15 SUGGESTED READINGS



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11.16 TERMINAL QUESTIONS



1. Define Capital Structure and its concept?
2. Differentiate between Capital Structure and Financial Structure?
3. Explain the Theories of Capital Structure and Factors Affecting Capital Structure.