

Financial Management

MS109

UNIT 8 CAPITAL STRUCTURE

MBA Second Semester

Compiled By: Dr. Manjari Agarwal

Capital Structure

The term 'Capital Structure' can be segregated into two words that are Capital and Structure. Structure is taken from the Latin word *structura* which means something that is made up of parts that are arranged in a certain way. Capital refers to the funds raised to support the functioning of business units. Capital Employed can also be represented as total assets minus current liabilities.

Equity represents the following;

- Equity Share Capital
- Preference Share Capital
- Share premium
- Reserve and Surplus
- Retained Earning
- Provisions for Contingency etc.

Debt comprises of the following;

- Debentures
- Long Term Loans from Banks and other Financial Institutions
- Long term borrowings
- All deferred payment liabilities

- Capital Structure refers to the proportion of long term sources of funds in the capitalization of the firm. The proportion of equity shares, preference shares, debentures, long term loan, retained earnings etc. constitute the firm's capital structure

- Gerstenberg defines “Capital Structure as the makeup of a firm’s capitalization.”
- Van Horne and Wachowicz “Capital Structure is the mix (or portion) of a firm’s permanent long-term financing represented by debt, preferred stock, and common stock equity”.
- Guthmann and Dougall stated that “capital structure may be used to cover the total combined investment of the bondholders including any long-term debts such as mortgages and long-term loans as well as original investment”.
- Kishore Ravi, “The term total capital structure denotes mix of owner’s funds and outsider’s funds or it is proportionate relationship of firms permanent long term financing represented by equity and debt.”

Capital structure influences the value of a firm by influencing the Earning Per share as well as by influencing cost of capital.

Optimum Capital Structure

- Optimum Capital Structure is the idealist expression or one can say quite theoretical because in the present competitive and unstable world it is really tough to find any optimum or ideal capital structure. Therefore it is better to refer appropriate capital structure or sound capital structure or relevant or target capital structure as these are more realistic as compared to optimum capital structure.

Features of Optimum Capital Structure

- Profitability
- Flexibility
- Solvency
- Liquidity
- Reduced Risk
- Control

Difference between Capital Structure and Financial Structure

Sr. no.	Capital Structure	Financial Structure
1.	It includes only long term sources.	It includes long term as well as short term sources of funds.
2.	It reflects only long term sources of funds that are reflected in the liabilities side of the Balance Sheet.	It reflects entire liabilities side of Balance Sheet. Thus, it is reflects asset structure of a company.
3.	It includes equity, preference shares, debentures, retained earnings, long term borrowings, etc	It includes equity, preference shares, debentures, other Long Term Liabilities, Loan from Bank. Mortgage, Current Liabilities, Sundry Creditors, Advance from Customers, Outstanding Expenses, Income Received in Advance or Short term borrowing etc.
4.	It denotes long term debt and shareholders fund.	Financial Structure denotes net worth or owners' equity and all liabilities.
5.	It does not include current liabilities.	It includes current liabilities for its calculation.
6.	It basically represents permanent financing of the firm.	It refers to the way in which the assets of the firm are managed and financed.
7.	Capital structure is a part of financial structure.	Financial structure includes capital structure.

Factors affecting Capital Structure

- **Profitability**
- **Nature of Industry**
- **Tax Issues**
- **Flexibility**
- **Earning Capacity**
- **Risk**
- **Growth rate**

- **Marketability**
- **Trading on Equity**
- **Legal provisions**
- **Size of the Company**
- **Attitude of the investors**
- **Issue Cost**
- **Control**

- **Purpose of Financing**
- **Government Policies**
- **Timings**
- **Characteristics of the Company**
- **Provision for Future**



Thank You !

References

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