UNIT 8 CAPITAL STRUCTURE

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8.1 INTRODUCTION

In the previous unit you learnt about the concept of cost of capital and you also gained an understanding of the methods required for the computation of the cost of capital raised through various sources. Now in the present unit, you will learn that it is imperative for an organisation to have an appropriate proper mix of various types of securities so that overall cost of capital is minimized and value of firm is maximised. Keeping this objective in mind, it is imperative for a company to devise a sound capital structure through a combination of debt, equity and hybrid securities that maximising shareholder's wealth.

8.2 OBJECTIVES

After reading this unit you will be able to:

- Know the concept of capital structure.
- Differentiate between capital and financial structure.
- Identify various factors affecting capital structure.
- Understand legal factors affecting capital structure.

8.3 CONCEPT OF 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. The funds brought in company in the form of debt and equity are represented as under;

Equity represents the following;

a) Equity Share Capital
b) Preference Share Capital
c) Share premium
d) Reserve and Surplus
e) Retained Earning
f) Provisions for Contingency etc.

Debt comprises of the following;

a) Debentures
b) Long Term Loans from Banks and other Financial Institutions
c) Long term borrowings
d) All deferred payment liabilities

Accordingly, 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. Capital Structure generally refers to the mix of debt and equity in the total capital of a company. It actually depicts the proportion of long term finances employed in a firm. The company's capital structure represents its investment and financing strategy. Let us study few of the definitions of capital structure given by financial wizards.

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."

Khan and Jain "Capital Structure is the proportion of debt and preference shares on a firm's balance sheet ".

Pandey I.M. "The term capital structure is used to represent the proportionate relationship between debt and equity".

Srivastava and Misra "Capital Structure decision refers to the proportion of debt and equity and finding out whether there is a capital structure that can be said to be optimum for the shareholders of the firm".

Thus, capital structure influences the value of a firm by influencing the Earning Per share as well as by influencing cost of capital. Thus, these decisions affect the earnings available to the owners of the company by influencing Earning Per Share. However, from the last definition it can be assessed that there is another aspect in capital structure which is generally termed as optimum capital structure. The optimum capital structure is basically that proportion of debt and equity that will maximise the value of the firm. In simple words, through right mix of debt and equity, value of a firm or a company can be magnified.

Thus, 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. This capital structure is decided by taking into account several factors including financial, personal, psychological and managerial factors. But since optimum capital structure is much discussed among finance professionals therefore, let us identify the features of an optimum capital structure.

Features of Optimum Capital Structure

The optimum capital structure has the following features;

a) **Profitability-** The optimum capital structure should augment profitability of the company. The same can be augmented by minimizing cost of capital or weighted average cost of capital. It should basically increase earnings per share.
b) **Flexibility-** The optimum capital structure should be such that whenever required a firm can easily raise the funds from the sources that are prudent at the given point of time. Thus, debt-equity mix should be such that it offers option of reduction or expansion of debt under different conditions or situations.
c) **Solvency**- The optimum capital structure should not affect solvency of the firm. There should be balance between debt and equity in such a way that at the time of adverse conditions, solvency is not threatened due to payments of interest or dividends. A company should not raise funds from too much equity or too much debt.

d) **Liquidity-** The optimum capital should provide liquidity to the firm. This means that capital structure should not have higher level of debt as higher debt may lead to greater outflow of cash. This outflow may create cash crisis of funds, thereby crushing liquidity position of the firm. Hence, capital structure should be devised in a way EBIT is adequate to cover all its debt obligations and fixed charges.
e) **Reduced Risk-** The optimum capital structure should not affect variability of earnings or returns. The risk may arise due to economic, macroeconomic factors, industry and firm centric factors. High debt proportion in the capital structure may affect returns and hence may threaten the solvency of a company. Therefore, high level of debt may lead to increased WACC which may further decrease market price of company's share.
f) **Control-** Optimum Capital Structure should ensure that the control of stakeholders of the company is not diluted. The capital structure should be so crafted that it involves minimum risk of loss of control of the company.

Thus, finance manager can work hard to find appropriate capital structure so that it can magnify value of the firm together with reduced cost of capital and risk to shareholders. Because of tax shield provided by interest payments, the debt employed by the company generally reduces the tax burden. However, debt so raised by the company also increases financial risk. Managers, therefore should plan that level of debt in the company that minimizes overall cost of capital, maximizes the profits available to the equity shareholders and hence increases the value of the company. Therefore, decision regarding capital structure is important for optimizing returns to the shareholders of the company. These increased returns to the stakeholders shall bring advantage over other companies in terms of Value and Cost of Capital. This is therefore hard core fact that the finance manager has to make parity between the ability to control the funds and the developments in the availability of the funds.

8.4 DIFFERNCE BETWEEN CAPITAL STRUCTURE AND FINANCIAL STRUCTURE

The following differences are observed 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	It reflects entire liabilities side of Balance Sheet. Thus, it is reflects asset

	liabilities side of the Balance Sheet.	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.

Let's take the following example to have more conceptual clarity regarding the difference between financial and capital structure;

Balance Sheet of XYZ Limited as on 31st March, 2019		
Assets		**Amount (In Rs.)**
Current Assets		
	Cash	15,000
	Accounts Receivables	15,000
	Inventory	30,000
	Prepaid Expenses	5,000
	Short-Term Investments	5,000
	Total Current Assets	70,000
Fixed (Long-Term) Assets		

	Long-term Investments	20,000
	Property, Plant, and Equipment	25,000
	Intangible Assets	10,000
	Total Fixed Assets	55,000
Other Assets		
	Deferred Income Tax	
	Others	
	Total Other Assets	-
Total Assets		**1,25,000**
Liabilities and Owner's Equity		
Current Liabilities		
	Accounts Payable	8,000
	Short-term loans	2,000
	Income Taxes payable	5,000
	Accrued Salaries and Wages	5,000
	Unearned Revenue	5,000
	Current portion of long-term debt	5,000
	Total Current Liabilities	30,000
Long-Term Liabilities		
	Long-term debt	30,000
	Deferred Income Tax	5,000
	Other	5,000
	Total long-term liabilities	40,000
Owner's Equity		
	Owner's investment	50,000
	Retained Earnings	5,000

	Total owner's equity	55,000
Total Liabilities and Owner's Equity		**1,25,000**
Debt Ratio (Total Liabilities / Total Assets)		0.56
Current Ratio (Current Assets / Current Liabilities)		2.33
Working Capital (Current Assets - Current Liabilities)		40,000
Assets-to-Equity Ratio (Total Assets / Owner's Equity)		2.27
Debt-to-Equity Ratio (Total Liabilities / Owner's Equity)		1.27

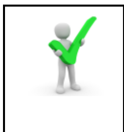
In the above example, the XYZ Limited is having Rs 125,000 as Total Liabilities and Owner's Equity and Total Assets are Rs 125,000. The current liabilities of the company are of Rs 30,000. Therefore, the Capital Structure of the company is equal to sum of Long Term Debt and Owner's Equity which is sum of Rs 40,000 and 55,000 i.e. 95,000. It can be calculated other way around as;

= Total Liabilities and Owner's Equity- Current Liabilities

= 1,25,000- 30,000=95,000

The Financial Structure of the company can be determined as below;

Financial Structure depicts equity capital, preference capital, liabilities, reserves and surpluses, long-term and short-term loans and current liabilities and provisions. Hence, Financial structure of XYZ Limited = 40,000+ 55000+ 30000= Rs 125000 hence, it refers the way how the resources in terms of entire assets of the company are utilized or employed.



Check Your Progress-A

Q1. What do you mean by Capital Structure?

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Q2. Differentiate between Financial Structure and Capital Structure.

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Q3. What are the key features of Optimum Capital Structure? Can there be an optimum capital structure for a firm?

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Q4. State True or False against the following.

a) The optimum capital structure should augment profitability of the company.
b) The capital structure should be such that it reduces the risk at the minimum level.
c) Financial Structure refers to short term funds deployed by the company.
d) The optimum capital structure should affect variability of earnings or returns.

8.5 FACTORS AFFECTING CAPITAL STRUCTURE

There are various stages at which capital structure is determined by the management. The first stage is at the time of the establishment of the Firm. At this stage, Management should be very careful while finding appropriate debt-equity mix because raising capital at this stage will have long term implications. Later stages involve decisions regarding target capital structure that are dependent upon the policies *per se* expansion, modernization, retrenchment policies of the firm. Accordingly, it is responsibility of the Finance Manger to wisely design the capital structure taking into consideration various factors that affect the judgment regarding debt and equity.

The following factors should be kept in mind while determining debt-equity mix of the company;

1. **Profitability-** Profitability of an organization is one of the key factors that influence capital structure of an organization. Stability in revenues generation determines whether to go for increase in debt in the capital structure or increase in equity. Further, capital structure should be such that it increases profitability of the organization as well as magnify the returns for equity shareholders. Accordingly, increase in debt in the capital structure results into increase in profitability as debt is cheaper in comparison to other sources of capital structure (as you learnt in the previous unit that this is due to existence of tax shield). But debt financing requires more cash to service debt in terms of interest payments and repayment of principal. Similarly, cash is also required for dividends payments and redemption of preference shares. Therefore, stability in profits is required for meeting these cash requirements. Hence, analysis of Rate of Return on Total Assets, Profitability Ratio etc. is important while deciding debt-equity mix for the company. Therefore, finance manager can plan the capital structure on the basis of predictions regarding expected sales and revenues.
2. **Nature of Industry-** This is a very important factor that affects the financing pattern of a capital structure. Companies where sales are affected by wide fluctuations should opt for low degree of financial leverage. Further, many times capital intensive industries also faces risk of nonpayment of debt obligations at the time of recession then such companies should follow conservative capital structure approach and accordingly should rely more on equity finances. Highly competitive industry should also have relatively higher proportion of equity as compared to debt. Industries that witness lesser competition can utilize fixed payment bearing securities for financing its assets as these companies can meet payments on the borrowed funds. Sometimes for the non seasonal and non cyclical businesses, even investments in current assets may be taken as the characteristics of fixed assets and hence may be financed by long term funds. In case of seasonal businesses, the funds may be financed by short term loan and advances at the time of peak seasons. The businesses that face large cyclical variations require flexible capital structure that can buffer against the risk associated with the fluctuations or else may also curtail the funds in case of unfavorable circumstances.
3. **Tax Issues-** Impact of Taxation issues on the capital structure also decides the funds raising alternatives for the company. Under the provisions of Income Tax Act, dividend payable on equity shares and preference shares are not deductible as hence raises the cost of equity funds. Further, interest on debentures or loans is deducted from the revenues and hence provides the firm an advantage of tax shield. The tax saving make the debt fund cheaper as compared to equity. Graham (1996a), Oversech and Voeller (2010), Handoo and Sharma (2014) and many others investigated that higher tax benefit of debt have significantly positive impact on company's financial leverage. Therefore, tax consideration plays a significant role while designing capital structure of the company. In Indian context, a firm should also act as per the provisions with regard to corporate taxation and dividend tax norms.

4. **Flexibility-** Capital Structure of a company should be flexible so that necessary adjustments can be made as per the changing conditions and circumstances. The structure should be such that company can easily raise funds whenever needed without much difficulty and hindrance. Generally, debt instruments has got greater flexibility in terms of issue and redemption, however in case of equity, company have to fulfill a lot of legal requirements, approval and compliances before buyback. Hence as compared to equity, debt has got greater flexibility for issue and payback. Further, company should also have scope in the borrowing power to meet uncertain circumstances and conditions. Further, in case of favorable capital market conditions, preference shares can also be raised instead of debt instruments to provide flexibility in the capital structure.
5. **Earning Capacity-** If the levels of EBIT is low with respect to Earning per Share then in such a case, equity is generally preferred to debt. However, if the EBIT is high with respect to EPS then debt financing is preferred in comparison to equity. If the Return of Investment is less than K_d then financial leverage will massively depress ROE and *vice versa* (Kishore Ravi)
6. **Risk-** In capital structure decisions, risk also plays an important factor while designing capital structure for a firm. Financial risk is additional risk that equity shareholder bears as result of the decision to finance debt. Further, equity shareholder inherently bears the business risk due to firm's operations however; debentures holders' doe not bear business risk because of obligatory fixed interest rate payments. Further, increase in debt ratio increases the risk faced by equity shareholders and hence have an effect on the cost of equity. Robert Hamada have quantified the effect of financial leverage on beta of the company;

$$\beta = \beta(U)[1 + (1 - T((D/E)] \ldots \ldots . H - 1$$

   The Hamada equation depicts how increase in debt/equity ratio increases beta. In this $\beta(U)$ is firm's unlevered beta and therefore beta would be dependent upon business risk which shall be a measure of the firm's basic business risk. (Bodhanwala Rubeh, 2006). In Hamada's Equation, D/E is the measure of financial leverage of the company. Further, business risk is influenced by demand, price, business cycles, competition levels, economic position and the likes. A firm with this high level of risk generally prefers equity to debt as there are fluctuations in the earnings. On the contrary, companies having low level of business risk prefer debt instruments as there are not much variability in the returns. Financial risk refers to additional variability per share and increased probability of insolvency that may accrue because of fixed cost sources of funds. Hence, these two risk aspects are important considerations before planning for capital structure.

7. **Growth rate** – Companies with high growth rate generally require extensive funds for its expansion activities. Such companies generally finance these additional funds from raising debt. The fast growing companies are generally dependent upon debt as

compared to equity or internal financing. Companies with stagnant growth rate should majorly go for equity financing to finance its asset structure.

8. **Marketability-** Marketability means readiness on the part of investors to purchase instruments at a given point of time and at given conditions. The acceptability of the issue of securities amongst general public also affects the capital structure decisions. This is also dependent upon the goodwill and reputation of the company in general public. But besides these, changes in market sentiments do impact the acceptability of the issues as sometimes, market favors safety, security regular income bearing securities and sometimes market sentiments are towards dividends and capital gains. Accordingly, Management should wisely takes the decisions of raising funds in the wake of general market conditions and internal policies of the company.
9. **Trading on Equity-** Trading on equity directly impact the capital structure of the company. A firm is said to be traded on equity if the Rate of Return on the shareholders funds along with long term borrowings is greater than the rate of interest on long term loans. In such a case leverage can give fruitful results in term of maximizing Earning per Share. However, if the rate of interest on long term loans or borrowing is greater than the expected rate of earnings then the leverage may adversely affect EPS. Therefore, as a Manager, you need to critically evaluate the impact of such decisions on Earnings per Share. In general, company can avail the advantage on Trading on equity when it has stability in earnings as debentures and preference shares bring a persistent obligation on the company to pay in recurring manner. In case if there are fluctuations in returns, company will face tremendous financial difficulties especially at the time of depression.
10. **Legal provisions-** The Management has to follow legal requirements and provisions regarding different type of securities to be issued by the company. For example, Banking Companies are not allowed to raise funds from debt based instruments. Raising funds from equity instruments requires more modalities to be completed as compared to debt funds. For example, as per Companies (Share Capital and Debentures) Rules, 2014 Company Limited by Shares can issue equity shares with differential rights as to dividend, voting or otherwise only when the articles of association of the company authorizes the issue of shares with differential rights.

    Taking another example of Companies (Share Capital & Debenture) Rules, 2014 from Section 71; "a Company may issue debentures with an option to convert into shares, wholly or partly, at the time of redemption but cannot issue debentures with voting rights. The following aspects need to keep in mind by the management while issuing debenture that;

    1. Debentures cannot be issued with voting rights.

    2. A company cannot issue debentures to more than 500 people without appointing a debenture trustee, whose duty would be to protect the interest of Debenture Holders and redress their grievances.

    3. On issue of debenture a company shall create a Debenture Redemption Reserve. (DRR).

11. **Size of the Company-** Size of the company is very important factor while determining the capital structure of the firm. Small size companies are heavily dependent upon owner's funds and internal sources of financing. Large size companies may raise funds from long term debt, equity, preference shares, convertible and non convertible debentures and other sources of securities and instruments. These companies are having strong basis for bargaining for obtaining funds. Further, these companies have to tap different sources of funds to cater their need other than internal sources available. Due to restrictive covenants in loan agreement, small companies many a times, struggle to obtain long term loans and hence they are dependent on ownership securities and internal financing for arranging funds.
12. **Attitude of the investors-** Investors profile for the company should also be assessed before taking decisions regarding sources of financing for additional funds. Different sets of investors assess risk differently, accordingly they expect dividend or interest payments.
13. **Issue Cost-** Issue Cost of different types of securities should also be weighed when raising funds. In general, cost of floating the equity is higher than the cost of floating debt, therefore in normal conditions; Management can exercise choice for debt financing. Financing from internal sources will not attract any cost of issue. Further, fixed cost for commercial papers and debentures is high as compared to private debt. The economies of scale are high for fixed cost bearing instruments (Pandey I.M). On the contrary, raising additional finances for reducing Cost of Issue Paper Security shall reduce financial flexibility of the firm an shall increase risk burden on equity shareholders, therefore trade off is required from the end of management to balance the flotation cost or cost of issue.
14. **Control-** The Management of the company also needs to ensure that raising funds does not involve dilution of control of the company. Owners of private held companies are extremely careful about the loss of control and hence they could raise additional funds by way of fixed interest on debt. Since, preference share capital, debenture holders, and bondholders do not have the right to vote; therefore when the promoters do not want to lose their stake in managing affairs of the company, they prefer Preference Shares or debentures over equity shares.
15. **Purpose of Financing-** The purpose of financing should also be kept in view by the Management while taking decision regard the capital structure of the company. If funds are raised for expansion, purchase of some asset purpose, replacement of plant and machinery then company can afford to raise the funds by the issue of debentures as out of the profits so earned, interest on debentures can be paid.
16. **Government Policies-** It is important to refer to the government policies while deciding the capital structure of the company. The guidelines, rules and regulation as issued time to time by Securities Exchange Board of India need to be referred while chalking out capital issue policies of the company. Further, Company Act should also be referred while planning for raising funds. For example, Section 71 of the Companies Act, 2013 deals with the provisions relating to the issue of debentures

along with the penalties for non-compliance. Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014 prescribes certain conditions to be fulfilled by a company in order to issue secured debentures. Monetary and fiscal policies also affect the capital structure decisions. As decrease in lending rates may force a firm to raise the funds from equity shares. Similarly, rigid capital market policies and regulation may force companies to seek for loans and advances from Banks and other Financial Institutions.

17. **Timings-** Timings also plays a vital role in developing framework for debt-equity mix. Timing of public offerings is yet again another consideration to be taken care by the Management of the company. Here, timing involves economic position of the country, stock market position, market sentiments, global trade scenario, monetary and fiscal policies, government policies, etc. Accordingly, on the basis of the above, one may decide whether to opt for debt or equity for raising additional funds. In case issue of equity is becoming scarce or expensive then the Management may raise funds from debt and *vice versa*. In case, company is expecting reduced interest rate in the near future then they may postpone borrowing at a later date availing the benefit of decreased interest rate. If the market sentiments prevailing are towards safety of capital then it is appropriate to raise funds from debentures or long term loans and *vice versa*.
18. **Characteristics of the Company-** Another consideration while designing capital structure is the key features of the company in term of size, credit worthiness, goodwill of the company and freedom of management in terms of decision making etc. Companies having high credit rating can easily obtain funds from the market. In case credit rating of the company is poor then it would be very challenging for the company to raise funds from the market.
19. **Provision for Future-** Provisions of future is another factor that should be kept in mind while designing capital structure. This means that these should always be scope of issuing securities or raising funds for unforeseen circumstances. Debt and Equity should not be employed to the fullest rather in large companies different type of securities should be given its place in debt-equity mix.

Check Your Progress- B

Q1. Discuss any six factors that influence decision makers in finalizing capital structure of a company?

Q2. Discuss how size of the company influences the planning of a capital structure?

Q3. Fill in the Blanks.

a) ____________________of different types of securities should also be weighed while raising funds.

b) A firm is said to be ____________________ if the Rate of Return on the shareholders funds along with long term borrowings is greater than the rate of interest on long term loans.

8.6 LEGAL REQUIREMENTS REGARDING CAPITAL STRUCTURE

The finance manager while deciding debt-equity mix of an organization should refer to the legal and regulatory framework regarding issue and redemption of securities and debentures. Generally, long term loans from Banks and Financial institutions require security of assets or mortgage of some property. Further, secured debentures also require some asset to be pledged. Further, guidelines as issued by SEBI time to time regarding issue and redemption of securities need to be referred by the finance manager. For example, at the time of filing of draft offer document and final offer document issuers has to ensure that it has applied to one or more approved stock exchanges and for the listing of such securities credit rating has been taken from at least one credit rating agency. Similarly, in case of seeking loans from Commercial Banks, requirements as issued by RBI should be fulfilled by the organization before applying for the funds.

Let us read few guidelines issued by Securities and Exchange Board of India that impact decisions pertaining to the capital structure;

"As per Securities and Exchange Board of India (Issue of Capital And Disclosure Requirements) Regulations, 2018, an issuer shall not be eligible to make an initial public offer if there are any outstanding convertible securities or any other right which would entitle any person with any option to receive equity shares of the issuer: Further Eligibility requirements for an initial public offer, are (1) An issuer shall be eligible to make an initial public offer only if: a) it has net tangible assets of at least three crore rupees, calculated on a restated and consolidated basis, in each of the preceding three full years (of twelve months each), of which not more than fifty percent are held in monetary assets: Provided that if more than fifty percent of the net tangible assets are held in monetary assets, the issuer has utilized or made firm commitments to utilize such excess monetary assets in its business or project;

Provided further that the limit of fifty per cent on monetary assets shall not be applicable in case the initial public offer is made entirely through an offer for sale. b) it has an average operating profit of at least fifteen crore rupees, calculated on a restated and consolidated basis, during the preceding three years (of twelve months each), with operating profit in each of these preceding three years; c) it has a net worth of at least one crore rupees in each of the preceding three full years (of twelve months each), calculated on a restated and consolidated basis; d) if it has changed its name within the last one year, at least fifty per cent. of the revenue, calculated on a restated and consolidated basis, for the preceding one full year has been earned by it from the activity indicated by its new name"

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Reference: Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, Retrieved from https://www.sebi.gov.in/legal/regulations/sep-2018/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-_40328.html, last accessed 10/2/2020

Let us refer to one of the rules that influence issue of share capital and debentures;

Companies (Share Capital and Debentures) Rules, 2014

"Company limited by shares can't issue equity shares with differential rights as to dividend, voting or otherwise, unless the articles of association of the company authorizes the issue of shares with differential rights; the issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders. the shares with differential rights shall not exceed twenty-six percent of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time; the company having consistent track record of distributable profits for the last three years; the company has not defaulted in filing financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares; the company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend; the company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a Public Financial Institution or State Level Financial Institution or Scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government".

Reference: COMPANIES (SHARE CAPITAL AND DEBENTURES) RULES, 2014, Retrieved from https://www.sebi.gov.in/sebi_data/attachdocs/apr-2017/1492085873402.pdf, last accessed 10/2/2020

Therefore, from the above decisions we may infer that while planning the capital structure of a company various rules and regulations issued by regulatory authorities should be referred by Finance mangers as these are one of the major determinants in capital structure.

8.7 SUMMARY

In this unit, you learnt that appropriate capital structure is an important decision for any organization. The company's capital structure represents its investment and financing strategy. Therefore, it is not only important for company's profitability and growth but it also give company an ability to deal with the competitive environment. While planning the capital structure, it should be borne in mind that there is no particular capital structure that need to be followed by an organisation rather these decisions should be taken by the Managers after considering numerous factors affecting the business entity.

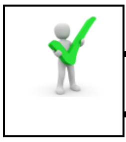
8.8 GLOSSARY

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 loans, retained earnings, etc. constitute the firm's capital structure.

Financial Structure depicts equity capital, preference capital, liabilities, reserves and surpluses, long-term and short-term loans and current liabilities and provisions.

Optimum capital structure is basically that proportion of debt and equity that will maximise value of the firm.

Trading on Equity refers to a situation where company earns higher rate of return on the capital employed as compared to the expenses incurred in paying fixed interest charges or dividend.



8.9 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

Q4. State True or False against the following.

a) True
b) True
c) False
d) False

Check Your Progress –B

Q3. Fill in the Blanks.

a) Issue Cost
b) traded on equity

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8.12 TERMINAL QUESTIONS

Q1. What are the various factors that influence capital structure decisions?

Q2. What do you mean by capital structure of a company? Discuss the various feature of optimum capital structure.

Q3. What do you mean by optimum capital structure? What are the various factors that influences optimum capital structure?

Q4. 'Optimal Capital structure does not exist in the real world'. Critically assess this statement.