DOWNLOAD PDF CAPITAL STRUCTURE DECISIONS NOTES

Chapter 1 : CIMA F3 Notes: Capital structure theories | aCOWtancy Textbook

Capital Structure Decisions What is capital structure? â€¢Combination of capital is called capital structure. The firm may use only equity, or only debt, or a combination of equity +debt, or a combination of equity + debt + preference shares or may use other similar combinations.

It is synonymously used as financial leverage or financing mix. Capital structure is also referred as the degree of debts in the financing or capital of a business firm. Financial leverage is the extent to which a business firm employs borrowed money or debts. In financial management , it is a significant term and an important decision in a business. In the capital structure of a company, broadly, there are mainly two types of capital i. Out of the two, debt is considered a cheaper source of finance because the interest payments are a tax-deductible expense. Capital structure or financial leverage deals with a very important financial management question. The other question which hits the mind in the first place is whether a change in the financing mix would have any impact on the value of the firm or not. The question is a valid question as there are some theories which believe that financial mix has an impact on the value and others believe it to be not connected. How can financial leverage affect the value? One thing is sure that wherever and whatever way one sources the finance from, it cannot change the operating income levels. The reason is explained further. Changing the financing mix means changing the level of debts and change in levels of debt can impact the interest payable by that firm. The decrease in interest would increase the net income and thereby the EPS and it is a general belief that the increase in EPS leads to increase in the value of the firm. Apparently, under this view, financial leverage is a useful tool to increase value but, at the same time, nothing comes without a cost. Financial leverage increases the risk of bankruptcy. It is because higher the level of debt, higher would be the fixed obligation to honor the interest payments to the debts providers. Discussion of financial leverage has an obvious objective of finding an optimum capital structure leading to maximization of the value of the firm. If the cost of capital is high Important theories or approaches to financial leverage or capital structure or financing mix are as follows: Net Income Approach This approach was suggested by Durand and he was in the favor of financial leverage decision. According to him, change in financial leverage would lead to a change in the cost of capital. In short, if the ratio of debt in the capital structure increases, the weighted average cost of capital decreases and hence the value of the firm. It says that the weighted average cost of capital remains constant. It believes in the fact that the market analyses firm as a whole which discounts at a particular rate which is not related to debt-equity ratio. Traditional Approach This approach is not defined hard and fast facts but it says that cost of capital is a function of the capital structure. The special thing about this approach is that it believes an optimal capital structure. Optimal capital structure implies that at a particular ratio of debt and equity, the cost of capital is minimum and value of the firm is maximum. MM theory proposed two propositions. It says that the capital structure is irrelevant to the value of a firm. The value of two identical firms would be same and it would not be affected by the mode of finance adopted to finance the assets. The value of a firm is dependent on the expected future earnings. It says that the financial leverage boosts the expected earnings but it does not increase the value of the firm because the increase in earnings is compensated by the change in the required rate of return. To summarize, it is essential for finance professionals to know about the nitty-gritty of capital structure they have suggested to the management. Accurate analysis of capital structure can help a company save on the part of their cost of capital and hence improve profitability for the shareholders.

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Chapter 2 : Evaluating A Company's Capital Structure

(viii) The capital structure can be altered without incurring transaction calendrierdelascience.comial Management Decisions THEORIES OF CAPITAL STRUCTURE: Equity and debt capital are the two major sources of long-term funds for a firm. the equity and the debt.e. now) D1 = Expected dividend at the end of Year total profits are distributed as dividends.

Clarifying Capital Structure Related Terminology The equity part of the debt-equity relationship is the easiest to define. A discussion of debt is less straightforward. Among financial analysts and investment research services, there is no universal agreement as to what constitutes a debt liability. This definition is too simplistic. Using a comprehensive total debt figure is a prudent analytical tool for stock investors. The new proposed rules certainly alert investors to the true nature of these off-balance sheet obligations that have all the earmarks of debt. In financial terms, debt is a good example of the proverbial two-edged sword. Astute use of leverage debt increases the amount of financial resources available to a company for growth and expansion. The assumption is that management can earn more on borrowed funds than it pays in interest expense and fees on these funds. However, as successful as this formula may seem, it does require that a company maintain a solid record of complying with its various borrowing commitments. Of course, the worst-case scenario would be having trouble meeting operating and debt liabilities during periods of adverse economic conditions. Lastly, a company in a highly-competitive business, if hobbled by high debt, may find its competitors taking advantage of its problems to grab more market share. Unfortunately, there is no magic proportion of debt that a company can take on. However, because investors are better off putting their money into companies with strong balance sheets, common sense tells us that these companies should have, generally speaking, lower debt and higher equity levels. The debt ratio compares total liabilities to total assets. Obviously, more of the former means less equity and, therefore, indicates a more leveraged position. The problem with this measurement is that it is too broad in scope, which, as a consequence, gives equal weight to operational and debt liabilities. Current and non-current operational liabilities, particularly the latter, represent obligations that will be with the company forever. Also, unlike debt, there are no fixed payments of principal or interest attached to operational liabilities. Expressed as a percentage, a low number is indicative of a healthy equity cushion, which is always more desirable than a high percentage of debt. Additional Evaluative Debt-Equity Considerations Companies in an aggressive acquisition mode can rack up a large amount of purchased goodwill in their balance sheets. A material amount of intangible assets need to be considered carefully for its potential negative effect as a deduction or impairment of equity, which, as a consequence, will adversely affect the capitalization ratio. Funded debt gives a company more wiggle room. Here again, this information should appear in the footnotes. A healthy capital structure that reflects a low level of debt and a corresponding high level of equity is a very positive sign of investment quality. Trading Center Want to learn how to invest? Get a free 10 week email series that will teach you how to start investing. Delivered twice a week, straight to your inbox.

Chapter 3 : Capital Structure: Concept, Definition and Importance

Capital structure can be a mixture of a firm's long-term debt, short-term debt, common equity and preferred equity. A company's proportion of short- and long-term debt is considered when analyzing.

But businesses also have to make capital decisions, determining the best projects to invest in to ensure growth and future profitability. Capital budgeting is how businesses make such decisions. Capital structure tells you where the money for capital projects comes from. Capital Budgeting Capital budgeting is simply the process of deciding which capital projects to pursue and which to reject. At any given time, a business may have countless projects it could pursue. Even a project as straightforward as opening a new store could go in multiple directions: For one thing, you only have so many resources. Also, some projects are mutually exclusive, and projects might not even be profitable when all costs are considered. Capital budgeting separates the promising projects from the bad ones. Methods Each business makes capital budgeting decisions in its own way, but all methods start with determining the upfront costs of a project and then forecasting the cash flows that will come from it. A simple method common in small business is the "payback" method: The NPV method involves adjusting all costs and cash flows to their present value accounting for inflation and other factors and then adding them up; if the total is positive, then the project is acceptable. Rationing Capital budgeting is not the same thing as capital rationing, although the two often go hand in hand. Capital budgeting simply identifies which projects are worth pursuing, regardless of their upfront cost. When a company has a finite amount of capital to invest -- a familiar situation to the small business owner -- capital rationing helps the business choose the projects it can afford that will produce the greatest return. One common method for doing this is the "profitability index. This tells you how much return you get for each dollar invested. In other words, it measures bang for the buck. A business can get money from two sources: Capital Budgeting About the Author Cam Merritt is a writer and editor specializing in business, personal finance and home design.

Chapter 4 : Capital Structure

CHAPTER: 1. 00 ORIENTATION OF THE TERM PAPER INTRODUCTION The term Paper tries to visualize "Capital Structure Decisions" and represent the facts that include features of Capital structure, determinants of capital structure, patterns or forms of capital structure, types and theories of capital structure, theory of optimal capital structure, risk associated with capital structure.

The capital structure decision can affect the value of the firm either by changing the expected earnings or the cost of capital or both. The objective of the firm should be directed towards the maximization of the value of the firm the capital structure, or average, decision should be examined from the point of view of its impact on the value of the firm. If the value of the firm can be affected by capital structure or financing decision a firm would like to have a capital structure which maximizes the market value of the firm. If average affects the cost of capital and the value of the firm, an optimum capital structure would be obtained at that combination of debt and equity that maximizes the total value of the firm value of shares plus value of debt or minimizes the weighted average cost of capital. For a better understanding of the relationship between financial average and the value of the firm, assumptions, features and implications of the capital structure theories are given below. In order to grasp the capital structure and the cost of capital controversy property, the following assumptions are made: Firms employ only two types of capital: The total assets of the firm are given. The degree of average can be changed by selling debt to purchase shares or selling shares to retire debt. The firm has a policy of paying per cent dividends. The operating earnings of the firm are not expected to grow. The business risk is assumed to be constant and independent of capital structure and financial risk. The corporate income taxes do not exist. This assumption is relaxed later on. The following are the basic definitions: The above assumptions and definitions described above are valid under any of the capital structure theories. David Durand views, Traditional view and MM Hypothesis are tine important theories on capital structure. The existence of an optimum capital structure is not accepted by all. There exist two extreme views and a middle position. David Durand identified the two extreme views â€” the Net income and net operating approaches. Under the net income Nl approach, the cost of debt and cost of equity are assumed to be independent of the capital structure. The weighted average cost of capital declines and the total value of the firm rise with increased use of average. Under the net operating income NOI approach, the cost of equity is assumed to increase linearly with average. As a result, the weighted average cost of capital remains constant and the total of the firm also remains constant as average changed. Thus, if the Nl approach is valid, average is a significant variable and financing decisions have an important effect on the value of the firm, on the other hand, if the NOI approach is correct, then the financing decision should not be of greater concern to the financial manager, as it does not matter in the valuation of the firm. The traditional view is a compromise between the net income approach and the net operating approach. According to this view, the value of the firm can be increased or the cost, of capital can be reduced by the judicious mix of debt and equity capital. This approach very clearly implies that the cost of capital decreases within the reasonable limit of debt and then increases with average. Thus an optimum capital structure exists and occurs when the cost of capital is minimum or the value of the firm is maximum. The cost of capital declines with leverage because debt capital is chipper than equity capital within reasonable, or acceptable, limit of debt. The weighted average cost of capital will decrease with the use of debt. According to the traditional position, the manner in which the overall cost of capital reacts to changes in capital structure can be divided into three stages and this can be seen in the following figure. The traditional view is criticised because it implies that totality of risk incurred by all security-holders of a firm can be altered by changing the way in which this totality of risk is distributed among the various classes of securities. Modigliani and Miller also do not agree with the traditional view. They criticise the assumption that the cost of equity remains unaffected by leverage up to some reasonable limit. It should however, be noticed that their propositions are based on the following assumptions: The securities are traded in the perfect market situation. Firms can be grouped into homogeneous risk classes. The expected NOI is a random variable 4. Firm distribute all net earnings to the shareholders. No corporate income taxes exist. Given the above stated assumptions, M-M argue that, for firms in the same risk class, the total market value is independent of the debt equity combination and is given by capitalizing the expected net operating income by the rate appropriate to that risk class. This is their proposition I and can be expressed as follows: According to this proposition the average cost of capital is a constant and is not affected by leverage. It defines the cost of equity, follows from their proposition, and derived a formula as follows: The crucial part of the M-M hypothesis is that Ke will not rise even if very excessive raise of leverage is made. This conclusion could be valid if the cost of borrowings, Kd remains constant for any degree of leverage. But in practice Kd increases with leverage beyond a certain acceptable, or reasonable, level of debt. However, M-M maintain that even if the cost of debt, Kd, is increasing, the weighted average cost of capital, Ko, will remain constant. They argue that when Kd increases, Ke will increase at a decreasing rate and may even turn down eventually. This is illustrated in the following figure. The shortcoming of the M-M hypothesis lies in the assumption of perfect capital market in which arbitrage is expected to work.

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Chapter 5 : Theories of Capital Structure (explained with examples) | Financial Management

The capital structure decision can affect the value of the firm either by changing the expected earnings or the cost of capital or both. The objective of the firm should be directed towards the maximization of the value of the firm the capital structure, or average, decision should be examined from.

The capital structure involves two decisions- Type of securities to be issued are equity shares, preference shares and long term borrowings Debentures. Relative ratio of securities can be determined by process of capital gearing. On this basis, the companies are divided into two- Highly geared companies - Those companies whose proportion of equity capitalization is small. Low geared companies - Those companies whose equity capital dominates total capitalization. For instance - There are two companies A and B. Total capitalization amounts to be USD , in each case. The ratio of equity capital to total capitalization in company A is USD 50,, while in company B, ratio of equity capital is USD , to total capitalization, i. In such cases, company A is considered to be a highly geared company and company B is low geared company. Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares. Trading on equity becomes more important when expectations of shareholders are high. Degree of control- In a company, it is the directors who are so called elected representatives of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights. Flexibility of financial plan- In an enterprise, the capital structure should be such that there is both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plans. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans. Therefore, a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors. Capital market condition- In the lifetime of the company, the market price of the shares has got an important influence. Period of financing- When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures. Cost of financing- In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits. Stability of sales- An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments. Interest on debentures has to be paid regardless of profit. Therefore, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases. Sizes of a company- Small size business firms capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.

Chapter 6 : Capital Structure - Meaning and Factors Determining Capital Structure

A company's capital structure is arguably one of its most important choices. From a technical perspective, the capital structure is defined as the careful balance between equity and debt that a business uses to finance its assets, day-to-day operations, and future growth.

Concept, Definition and Importance Article shared by: Concept of Capital Structure: The relative proportion of various sources of funds used in a business is termed as financial structure. Capital structure is a part of the financial structure and refers to the proportion of the various long-term sources of financing. It is the permanent financing of a firm represented by long-term debt, preferred stock and net worth. So it relates to the arrangement of capital and excludes short-term borrowings. It denotes some degree of permanency as it excludes short-term sources of financing. Again, each component of capital structure has a different cost to the firm. In case of companies, it is financed from various sources. In proprietary concerns, usually, the capital employed, is wholly contributed by its owners. In this context, capital refers to the total of funds supplied by bothâ€”owners and long-term creditors. It depends on the financial policy of individual firms. In one company debt capital may be nil while in another such capital may even be greater than the owned capital. The proportion between the two, usually expressed in terms of a ratio, denotes the capital structure of a company. Definition of Capital Structure: Capital structure is the mix of the long-term sources of funds used by a firm. It is made up of debt and equity securities and refers to permanent financing of a firm. Various authors have defined capital structure in different ways. Some of the important definitions are presented below: In the words of P. It may be defined as the proportion of debt and equity in the total capital that will remain invested in a business over a long period of time. Capital structure is concerned with the quantitative aspect. A decision about the proportion among these types of securities refers to the capital structure decision of an enterprise. Importance of Capital Structure: Decisions relating to financing the assets of a firm are very crucial in every business and the finance manager is often caught in the dilemma of what the optimum proportion of debt and equity should be. Capital structure is usually designed to serve the interest of the equity shareholders. Therefore instead of collecting the entire fund from shareholders a portion of long term fund may be raised as loan in the form of debenture or bond by paying a fixed annual charge. The importance of designing a proper capital structure is explained below: Capital structure maximizes the market value of a firm, i. By determining a proper mix of fund sources, a firm can keep the overall cost of capital to the lowest. Increase in Share Price: It also increases dividend receipt of the shareholders. Capital structure increases the ability of the company to find new wealth- creating investment opportunities. Growth of the Country: Patterns of Capital Structure: There are usually two sources of funds used by a firm: A new company cannot collect sufficient funds as per their requirements as it has yet to establish its creditworthiness in the market; consequently they have to depend only on equity shares, which is the simple type of capital structure. After establishing its creditworthiness in the market, its capital structure gradually becomes complex. A complex capital structure pattern may be of following forms: Equity Shares and Debentures i. Equity Shares and Preference Shares, iii. Equity Shares, Preference Shares and Debentures i. However, irrespective of the pattern of the capital structure, a firm must try to maximize the earnings per share for the equity shareholders and also the value of the firm.

Chapter 7 : What Are Capital Budgeting and Capital Structure? | calendrierdelascience.com

Capital Structure Decisions - Relevant textbook pages - none - The optimal capital structure is the one that maximizes the price of the firm's stock.

Chapter 8 : Capital Structure and its Theories

A decision about the proportion among these types of securities refers to the capital structure decision of an enterprise.

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Importance of Capital Structure: Decisions relating to financing the assets of a firm are very crucial in every business and the finance manager is often caught in the dilemma of what the optimum proportion of debt and.