

A descriptive study on Capital structure determinants

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Abstract

Capital structure is the long-term funding strategies of an organisation. The concept of "total capital structure" pertains to the manner in which an organisation secures long-term funding, encompassing both internal and external contributions. When selecting its financing mix, a company ought to optimise its value while reducing its overall cost of capital. Frequently, the dilemma of determining the ideal debt-to-equity ratio confronts financial managers. The financial structure, or capital structure, of a business entity delineates the manner in which it consolidates different types of financing in order to support its operational activities. Developing economies, such as India's, must prioritise the identification and analysis of the funding dynamics pertaining to their most significant contributory industry. Capital utilisation and the capacity of a business to secure funding are both critical determinants of its success and the overall vitality of the sector. This study demonstrates the significant factors that influence the capital structure, which is crucial for the practical application of financial studies.

Keywords: capital structure, debt-equity ratio, finance, industry.

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Introduction

Capital structure refers to the permanent financing of a business and consists of both equity and debt securities. The allocation of distinct forms of long-term capital comprises company-issued debentures, equity capital, preference capital, and long-term bank financing. A disparity is discernible among various forms of long-term capital, including company-issued debentures, inclination funding, equity funding, and long-term bank loans. The financing combination of a business should improve its market position and reduce its total cost of capital. As a prevalent indicator of a company's capital structure, the debt-to-equity ratio of its total capital is utilised. Given that any combination of these resources may be utilised by a business to fulfil its financial obligations, consequently, these may constitute the exclusive sources of capital for a company. Averaging the two terms "structure" and "capital" has been the case for the duration of documented history. Capital represents the enduring reserves of a business. The direction of financing alternatives

influences liabilities and equity, whereas investment decisions influence assets. Capital is the quantity remaining on the balance sheet after current liabilities are subtracted. Capital can be alternatively defined as the difference between the value of all current liabilities and all assets. An alternative approximation for categorising a firm's capital is as debt or equity. In the context of financial statements, the financial structure of a company is denoted by the current obligations listed on the left-hand side (equivalent to the asset structure). It is widely acknowledged that interest rates tend to increase in tandem with the debt-to-equity ratio, which signifies the proportion of debt to total capital. To afford the additional cost of interest, the organisation must possess trust in its capacity to generate a consistent rate of return. The cost of capital, in a similar fashion, is merely one of numerous factors that can influence profitability. In all cases, capital expenditures and profitability should be inversely proportional. Investment in capital expenditures consequently leads to a decline in profitability. Due to the fact that an escalation in debt leads to elevated interest payments, the organisation must contemplate the ramifications of this. Prior to delving into the topic of a company's funding, it is advantageous to establish clear definitions for the terms "capital structure" and "money-related structure." In order to enhance the development and value of its capital, an organisation ought to seek a financing boost. Simultaneously, it has been noted that enhancing the timing of capital acquisition results in decreased financing expenses and an augmented valuation of the organisation. Failed businesses have often been associated with the financing practices of the companies. Therefore, knowledge of financing acquisitions is critical for managers to effectively enhance the performance of their organisations. This study endeavours to gain an understanding of the process by which companies select their various important determinants of the capital structure, which is applicable to all the studies in this area.

Literature Review

Jain's (2019) research indicates that several characteristics of businesses are directly associated with their capacity to secure financing. The study's findings indicate that the corporations maintained leverage ratios at historically low levels. Long-term finances are characterised by a high level of specificity, whereas small-scale investment is comparatively more encompassing. Polish enterprises generated an insignificant amount of new employment opportunities. The research study by Lakshmi Sundar (2018) examines the comparison between static trade-off and pecking order models of capital structure. This study investigated the efficacy of traditional capital structure models in relation to corporate financing pecking order models. The act of soliciting external debt financing due to an insufficient amount of internal money is indicative of a fundamental need for financial assistance. In a study conducted by Kodongo (2017), the relationship between leverage and financial outcomes was investigated. The aforementioned inquiries were directed at Kenyan corporations that are listed on the stock exchange. Data collection for analysis was conducted annually from 2013 to 2016 as part of the study. Businesses can be influenced by a diverse range of factors that impact their success. Tangible assets, revenue growth, and company size are three key determinants of profitability. The findings indicate a negative relationship between the physical nature of assets and their financial gains. The value of a company is primarily defined by its size, the rate at which its sales are growing, and the extent to which small enterprises are included in it. Masidonda (2017) did a study to elucidate the intricacies of a company's capital structure. The researcher extensively explored multiple theoretical frameworks that addressed the issue of effectively distinguishing between different types of capital. The main objective of this study is to understand the impact of CEO competence, profitability, non-debt tax shields (NDTS), cash flow, and CEO ownership on capital structure. The study revealed that capital structure has no impact on cash flow. Instead, cash flow is influenced by the competence of the CEO, profitability, non-debt tax shields (NDTS), and the CEO's influence. Ahmed Hasan conducted research in 2016 to investigate the impact of capital structure on a company's success. The research was carried out in Dhaka, Bangladesh. From 2011 to 2015, the researcher conducted a survey of 35 Bangladeshi companies that were listed on the DHAKA Stock Exchange. In this study, one performance metric was designated as the dependent variable, while another was designated as the independent variable. Earnings per share (EPS), return on equity (ROE), return on assets (ROA), and Tobin's Q are instances of dependent variables. The independence of the other variables is assessed using the ratios of present debt, future debt, and total debt. A substantial negative association was observed between return on investment (ROI) and capital structure. There is no statistically significant correlation between the way a company is financed and its performance, as indicated by the metrics of return on equity (ROE) and Tobin's Q. Mohammad Hussain (2016)

conducted a study on the impact of capital structure policy on a company's worth. The data used in this study was compiled using both primary and secondary sources. The study gathered input from 80 participants who represented 20 distinct organisations. These companies are prominent manufacturers that have been listed on the Dhaka Stock Exchange. The analysis was limited to the years 2011–2015 due to a specified time constraint. Nishant Jain's 2015 study, titled "Factoring Legislation Conditions," examines the variations of these circumstances in different jurisdictions and marketplaces. This study illustrates the presence of variations in the terminology used across different countries. This survey encompassed both domestic and international corporations that have been publicly traded on a stock exchange, with a specific emphasis on the Asian market. The study conducted a survey of 1,000 individuals employed by 120 distinct publicly traded corporations across the globe. Chavarkar (2015) conducted an analysis of the advantages and disadvantages of utilising a computerised accounting system specifically for small and medium-sized firms in the North-East Mumbai Zone. She conducted more than one hundred national and international tests to arrive at the conclusion that computerised accounting systems (CAS) are a major challenge faced by Indian SMEs and their financial management. In a study conducted by Sable (2018), a total of 354 people from the areas of Malad, Dadar, and Ghatkoper in Mumbai were polled. The purpose of the study was to assess the level of satisfaction among small-scale entrepreneurs from the Jain community regarding the current financial business environment in the country. Based on the survey findings, small-scale company owners within the Jain community express contentment with their current financial status.

Determinants of capital structure

The capital structure of a corporation is influenced by a diverse array of variables, each of which has its own significance. The capital structure of a corporation should generally consider the following factors:

Trading on equity and EBIT-EPS analysis

The influence of financial leverage on earnings per share makes it a significant consideration when determining a company's capital structure. Companies with a high level of earnings before interest and taxes (EBIT) can profit from employing a significant amount of leverage in order to optimise the return on shareholders' equity. A financial manager commonly uses an EBIT-EPS analysis as a tool to get a valuable understanding of the company's capital structure. Using different funding scenarios, he may evaluate the effect of prospective changes in EBIT on EPS. Financial leverage enhances earnings per share (EPS) in favourable circumstances, although it concurrently amplifies financial risk for shareholders. Hence, the corporation ought to employ debt in a manner that does not jeopardise the leverage advantage due to financial risk.

Growth and sales stability

This factor significantly impacts the financial framework of a corporation. Regular sales lead to regular profits, enabling the company to easily meet its set obligations, such as interest and debt repayment. That way, more debt can be raised for the company. Likewise, the pace at which sales increase affects the decision about the composition of capital. Typically, a company's capacity to utilise debt for financial purposes expands in tandem with its sales growth rate. Nevertheless, in the event of sales exhibiting significant volatility and a downward trend, the corporation ought to exercise utmost prudence while using loan funds.

Cost of Capital

The expense associated with obtaining cash is an additional crucial factor to take into account while strategizing a company's capital structure. Optimising a company's capital structure is crucial in order to minimise its cost of capital. The cost of capital refers to the rate of return that would sufficiently satisfy the sources of capital. Equity capital is the costliest form of financing, as equity stockholders bear the primary responsibility for the company's potential losses. Debt capital is the most cost-effective choice, as the company is obligated to pay interest regardless of its profitability. Furthermore, the interest incurred on debt capital is eligible for a tax deduction. Preference shares offer a higher level of affordability compared to common stock due to the assured dividends they provide. Therefore, the overall cost of

capital is directly related to the combination of financing techniques utilised. Hence, it is imperative to exercise caution when formulating the capital structure in order to minimise the cost of capital.

Control

The current management's desire to maintain control over the company may influence the design of its capital structure. When a company requires additional funds, the management seeks ways to acquire them without relinquishing their authority over decision-making. The issuance of new equity to finance operations diminishes the voting power of existing shareholders. To raise the needed funds, the company may opt to issue fixed charge-bearing debt and preference share capital, as these do not grant.

Flexibility

Flexibility refers to a company's capacity to adjust its capital structure in accordance with changing conditions. The capital structure must possess the flexibility to efficiently and expeditiously secure additional funds, should the need arise. To optimise cost savings, the organisation should have a financial structure that facilitates seamless transitions between various funding sources. Preference shares and debentures offer the highest level of flexibility in the capital structure because they can be redeemed at the company's discretion.

Marketability and Time

Periodically, the condition of the capital markets may undergo changes. The market is currently either in a state of decline or in a state of rapid growth. When making a decision on whether to offer equity or loan funding, the company should carefully consider market attitudes in conjunction with other relevant criteria. During periods of stock market decline, corporations generally opt for debt financing instead of issuing new equity. Conversely, during a period of prosperous economic activity, the act of issuing additional shares of stock serves as a straightforward method to generate funds. The marketability of securities can also be influenced by internal issues within the organisation. A corporation with a high level of leverage may encounter difficulties in obtaining additional loans. Likewise, a corporation that is excessively small to issue any form of security on the market may encounter difficulties in raising funds.

Floation Cost

Floation charges have a minimal impact on the capital structure decision. When external funds are acquired, it is necessary to pay such fees. Brokerage fees, commissions, and the expenses associated with issuing a prospectus are all encompassed within this category. Debt generally has a lower float cost compared to equity. Hence, there may be a temptation to use debt finance. Retained earnings do not incur any variable expenses. As previously mentioned, floation charges have minimal significance for all except the most diminutive enterprises. When calculating the overall funds to be obtained, it is important to consider the floation expenses, as they decrease in proportion to the size of the securities being issued. Therefore, as the floation costs decrease, the size of the issue increases. However, a significant issue hampers the company's financial flexibility.

Financing Reasons

When determining the capital structure, it is important to consider the fundraising objectives. Debt capital is suitable when the cash will be used for productive endeavours, as the interest can be reimbursed from the returns generated by the investment. However, if the utilisation is not yielding positive results, preference should be given to fairness and justice.

Legal Purposes

When strategizing a firm's capital structure, it is crucial to consider the dynamic regulations set by the government regarding the issuance of equity and debt. The presence of legal restrictions establishes a framework within which determinations about capital structure must be formulated, rendering them highly significant.

Conclusion

The current study illustrates several key components that influence the capital structure. Trading on equity, also known as leveraging, is the utilisation of fixed-income securities such as long-term debt and preference share capital, in addition to equity share capital, for investment purposes. Regarding sales, the corporation faces minimal difficulty in meeting its set obligations, such as interest and debt payments. Price of It is crucial for a firm to manage its capital structure in order to minimise its cost of capital. Another factor that influences the desire of the current management to maintain control of the company could potentially affect the design of the company's capital structure. The capital structure should possess sufficient adaptability to efficiently and promptly secure additional funds, as and when required. Marketability and time indicate that the situation of the capital markets may undergo a change. The market is currently in a state of uncertainty, with the possibility of either a downturn or an upturn. Floatation cost refers to the expenses incurred while obtaining funds from external sources, such as fees that need to be paid. Brokerage fees, commissions, and the expenses associated with issuing a prospectus are all encompassed within this category. When determining the capital structure, it is important to consider fundraising objectives for financing purposes. When strategizing a company's capital structure, it is crucial to consider the dynamic regulations set by the government on the issuance of shares and debt for lawful purposes.

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